THE THEORY OF EXCESS PROFITS TAXATION

TO
THE MEMORY
OF
MY PARENTS

THE THEORY OF EXCESS PROFITS TAXATION

(With particular reference to India)

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PREFACE

The era of free enterprise is gone. The age of central controls has come, perhaps as a prelude to that of socialisation. This change-over is the inevitable process of the old order yielding place to the new, even as the replacement by an enterpreneur of old plant and processes by new and improved ones. Free enterprise, control and nationalisation are mere means to attain the goal of optimum social welfare and may, over a number of generations, cyclically succeed one another. Planned economy is, thus, a natural successor to the free play of economic forces.

The period of transition from one way of economic life to another is always trying and unpleasant, and will upset, especially, vested interests and entrenched institutions. And at such a juncture the cry of " Free enterprise in danger ", like that of " Religion in danger ", is always raised and brings together strange bed-fellows. When Republican and conservative Democratic senators in America got together to keep Henry Wallace, the Secretary of State, from being placed in charge of the powerful federal loan agencies, they did it in the name of preserving free enterprise from the meddling of a dangerous radical. When Henry Wallace himself outlined his ideas for using the vast resources of the American Government to encourage little businesses and guarrantee the abnormal risks of post-war reconstruction, he insisted he was for free enterprise. When the National Association of Manufacturers urged a sales tax, the right to sue trade unions and 'protection' of workers from being coerced into unions, it spoke in the name of free enterprise.[1]

Not only is free enterprise played out, but also socialisation appears inevitable—only the forms,

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1 *Vide The Economist* 31st March 1945 p. 413

degree and pace of change may differ in different conjunctures according to the urgency of the need, the extent of the entrenchment of tradition and free enterprise, and the resources in men and materials to work out the change. It may be sudden and avalanchine as in the U.S.S.R., slow and creeping as in the U.S.A. or evolutionary as in the U.K.

One of the methods of peaceful transition is through the instrumentality of public finance. "It is an inestimable gain," observed the *Economist* in 1942,[1] "that for the first time in British history, and probably for the first time in any country, public finance is now openly regarded, not as an independent mystery, but merely as a part of the wider whole of social and economic policy. Perhaps the best founded hope for a sounder and more successful economic policy after this war than after the last rests on this departure." The departure is based as much on a reorientation of public finance as on harnessing it to further social policy. The machinery of differential taxation can be utilised to stimulate or retard the flow of investment in socially predetermined directions. Thus, the processes of production and distribution and the floor and ceiling levels of incomes—below which no income shall fall and above which no income shall rise—can be controlled by direct taxation.

Since the beginning of this century, and especially since the First World War, the income tax, sur tax and death duties have been exploited successfully towards the removal of great disparities of wealth. Little, however, has been done by taxation on the production side. The following pages point out how the Excess Profits Tax could fill the gap and serve the social purpose. By a proper utilisation of this tool the traditional advantages of free enterprise—efficiency, initiative, responsibility and freedom—can be retained along with an enlargement of central control

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1 11th April 1922 p. 491

and government functions. The advantages of both individualism and totalitarianism can be enjoyed by purging the former of its defects and abuses and by safeguarding variety in life through the bridling of the profit motive. While accepting the inevitability of socialisation, this book attempts to indicate how the excess profits tax can help the realisation of Keynes' hope:[1] "Though in the ideal commonwealth men have been taught or inspired or bred to take no interest in the stakes, it may still be wise and prudent statesmanship to allow the game to be played subject to rules and limitations, so long as the average man, or even a significant section of the community, is, in fact, strongly addicted to the money-making passion."

The book is divided into two parts. The first part discusses the theory of the tax and each of the six chapters has a specific objective. Chapter I indicates how the excess profits tax—by whatever name it was called—is an old tax much anterior to the First World War; Chapter II analyses the ability-to-pay concept, suggests a reorientation of the canons of taxation and evolves the *Principle of Excessivity*; the next chapter points out, with particular reference to India, the prevalent tendency towards abnormal profits and analyses the long inter-War period (1918-1939) representative of booms, normalcy and depression; for, however perfect a tax is in theory, its success depends on its applicability. Chapter IV gives in outline the structure of a premanent tax pointing out how the taxable excess can be arrived at. Chapter V discusses the most important aspect of a tax, its effects; it argues that prices will not be affected and production not hampered but perhaps even encouraged, and that the tax can be converted into a valuable instrument of planning. Chapter VI deals with the objections and alternatives to the tax.

The second part of the book is descriptive and

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1 *General Theory* p. 374

comparative. Chapter VII deals with the history and structure of the tax in India against the background of theory and the experience of other advanced countries. In the light of the proverbial poverty and inequalities and the contemplated planned economy in the country, suggestions are made for an equitable and practicable permanent tax.

On account of difficulties of publication, it has not been possible to include two chapters in the first part—the Concept of Profits and the Problems of Administration—and three in the second—the British Example, the American Experimcnt and the Experience of Other Countries. It is hoped to publish these early.

I make no claims to original ideas. I have followed the footprints of others and have only synthesised and substantiated, perhaps developed, a few of their thoughts. The outlook has been *partly* Keynesian. "The state will have to exercise," wrote Keynes, "a guiding influence on the propensity to consume, partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps in other ways. . . A somewhat comprehensive socialisation of investment, will prove the only means of securing an approximation to full employment, though this need not exclude all manner of compromises and devices by which public authority will cooperate with private initiative. . . . If the state is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary. Morever, the necessary measures of socialisation can be introduced gradually and without a break in the general tradition of society." These pages offer one type of solution bridging the gulf between the decaying nineteenth century Capitalism and the spreading twentieth century Socialism, with the case of India always kept in view.

This book is not a *post mortem*. Much of it was ready by 1941 and I hoped to publish it in 1942 during the lifetime of the excess profits tax in India. But "exigencies of public service" prevented its completion. And in an atmosphere uncongenial to research work it has been a struggle to bring it out.

I have freely drawn upon many of the sources mentioned in the bibliography, especially *The Economist*, R.M. Haig's *Report* and Josiah Stamp's writings, and I hereby acknowldedge my indebtedness to them. While referring in the succeeding pages to the many authors, I have avoided the prefixes such as Prof., Dr. and Mr. but no discourtesy is meant. I thank the Editor, Half—Yearly Journal of the Mysore University for loaning the blocks of the graphs and for permission to utilise in Chaps. III and IV the data in my articles published in that Journal.

Finally, I thank numerous friends for words of encouragement and Mr. G. H. Rama Rao, & the Mysore Printing & Publishing House for readily undertaking the printing of the book.

PRINCESS ROAD, VONTIKOPPAL
MYSORE

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CHAPTER I

The Historical Background[1]

Introductory: All financial emergencies have inevitably led to great changes in the financial systems of the world: Increase in the rate and variety of taxes as well as in public borrowing has engaged the ingenuity of financiers. New methods of plucking the goose have been invented and old ones perfected. Such was the case with the income tax and the death-duty, and such is the case with the excess profits tax. Thus, it was the Napole-anic struggle that gave Great Britain her income tax. This impost was, no doubt, known much earlier and, also, it took years before it was tolerated as a regular burden or developed as the best of taxes. Neverthe-less, except for the great financial stress felt by Pitt, Great Britain and the world would have perhaps waited decades before adopting the tax which forms to-day financially the most productive, theoretically the least imperfect and ethically the most equitable of all taxes. In our own country the story is similar. The Indian income tax owes its origin to the 1857 disturbances. Increased expenses, particularly in defence and interest charges in 1857–60, compelled James Wilson to introduce the tax. Brought in as a temporary measure, the income tax was repealed and reintroduced under different names according as the finances of the government showed a surplus or a deficit. It was only towards the end of the last century that the tax became a permanent feature of our financial system and only in 1939 that some of the outstanding defects in the Indian ineome tax were remedied.

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1. In view of the comparative account in part II of this book only the barest outline is given in this chapter.

The excess profits tax, rightly characterised as the most revolutionary development in public finance since the introduction of the income tax, is having a similar experience. It is, however, inaccurate to believe that the tax is modern. "The great War," wrote Carl Plehn [2], "has apparently given the world a new tax, the excess profits tax.... This tax is new in the sense that it singles out a form of profits—war and excess profits—never here-to-fore separately distinguished as a tax base; and is new also as to the social justification upon which it rests." This view is not accurate, because long before the war of 1914 the excess profits tax had been discussed in theory and levied in practice.

More than 2,000 years ago it was imposed by the Mauryan financiers in India and was known as *parsva*.[3]

Mauryan India

Businessmen were allowed a profit of 5% on local commodities and 10% on foreign goods. The percentage of normal profit was determined after a consideration of many factors such as the cost of production, demand and supply in the market, taxes already paid, transport charges and other kinds of accessory expenses. The supply was so regulated that in slack seasons the merchant did not suffer while in other seasons the State took care that he did not get undue profits. If there was any profit in excess of the normal rate, which the businessman managed to get either by illicit increase of price or by other means, the excess was taxed, in addition to the imposition of a fine on the merchant for breaking the law. This tax in the Mauryan Empire was not merely a device adopted in great financial difficulties but a regular tax in normal peaceful times. It is possible to contend that the rate of normal profits, viz: 5% and 10%, was too low and must have hit the businessmen a little too hard,

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2. War Profits and Excess Profits Taxes; *A.E.R.* 1920, p. 283
3. *Vide* M. H. Gopal; *Mauryan Public Finance.*

for the State appears to have given great importance to the consumers' point of view.

Two thousand years later, in 1863, the State of Georgia in the United States of America levied a profits tax of the Capital Standard type.

Georgia :

This levy has generally been referred to as an income tax, even by such an acute thinker as Seligman,[4] and the misnomer was largely the result of unfamiliarity with the excess profits tax at a time when the income tax itself was comparatively new and also because the Georgian tax was levied along with other States which stuck to the true income tax. "The restriction of the tax", observed W. A. Shelton,[5] "to certain traders and manufacturers who were known to be making large profits and the further restrictions to net profits of 20 per cent and above, indicates that the tax was aimed at excessive profits." The following description brings out the true nature of the impost and also points out how identical were the origin and criticisms of the tax in 1863-66 and in 1917-21.

The tax was introduced for the first time in 1863 during the Civil War, partly because of the demand for increased revenue and partly because of the general conviction that certain profit-makers were escaping their due share of the tax burden. "We believe it is right", felt the Georgian General Assembly,[6] "for those who, by the exigencies of war have been enabled by speculation, government contracts, extortion and otherwise to make extraordinary incomes amounting in some instances to huge fortunes for themselves, to pay liberally towards the support of government." The ethical purpose of the tax was emphasised by the Comptroller-General of Georgia

4. The *Income Tax*

5. The Income tax in Georgia. *J. P. E;* 1910, P. 614.

6. *House Journal*, 1862 P. 245—47, quoted in *J. P. E.*, Vol. XVIII, No. 8. P. 611

in these words[7]: "As the traders and speculators in these common necessaries of life had not only made large profits upon their neighbours at home, but also upon the soldiers and their families at home, the Legislature provided that the tax raised from this source should be distributed among the families of indigent soldiers."

The tax was applicable to certain trades and manufactures and was graduated in accordance with the rate of profits on invested capital. Profits, if less than 20 per cent, paid a tax of half a per cent, if between 20 and 30 per cent, the rate was one and a half per cent, and for every increase of 10 per cent in profits, the rate of tax increased by half a per cent *ad infinitum*. If the profits equalled 100 per cent of the invested capital, the rate wat 5 per cent; if 1000 per cent, the tax was 50 per cent and the entire profits were taken away if profits amounted to 2000 per cent. The tax was levied on the net income of the preceding year.

Evasion of the tax became common and the law was modified in December 1863. It was extended to some other trades; the administrative clauses were made stricter; the untaxed normal rate was lowered to 8 per cent; the minimum rate of tax was fixed at 5 per cent, and not half a per cent as under the earlier law, while the maximum was limited to 25 per cent of the entire profits instead of 100 per cent. In November 1864 and April 1865 further modifications were introduced and in March 1866 the tax was abolished. The degree of the success of the levy has been a disputed matter. Kinsman regards it[8] as an "unprecedented success" while Shelton considers[9] it a failure. Perhaps the latter opinion is more accurate.

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7. Comptroller General's Report 1863, P.29. Quoted in *ibid*.
8. The Income tax in the commonwealths of the United States *Publications of A. E. A.* 3rd series, IV, 1903, P. 96
9. *Op. cit.* P.626. Also see Seligman - *Income Tax*

Whatever its success, its course in Georgia and the opposition it roused found a remarkable echo during the First World War as well as the Second one. "I am free to confess", observed the Comptroller General of Georgia in 1864,[10] "that I have felt satisfied that there has been so much fraud and hard swearing or to say the least of it, so many different opinions relative to income tax returns, I have but little partiality for the system. So far as my observation extends, only a few whose business was such that they could not hide, if they would, have paid most of this tax . . . The real sharper or monopoliser and speculator who did no regular business but buy up produce, etc. and holds it up for high prices gets off by dodging the receiver, or claiming to have made no profits above 8 per cent."[11]

Prussia

Towards the end of the 19th century, a profits tax was levied in Prussia for local benefit.[12] Known as a business tax, it was imposed in addition to the income-tax and was based upon the ratio of profits to the capital of a concern. Businesses were classified into different groups on the basis of their profits and the tax for each class was graded according to their estimated earnings. Difficulty was, no doubt, felt in ascertaining the value of the business and the amount of annual earnings.

Adams' Proposal

In the beginning of this century, H. C. Adams[13] of America proposed an excess profits tax as a necessary accompaniment of railway rate regulation, on the ground that there was surplus value inherent in the property of a prosperous railway. "What is the source", he asked,[14] "the social character and the

10. *Report of the Comptroller General* 1864. P.36 (*J. P. E.* 1910, P.624)

11. For the experience in 1921, *vide A.E.R.* 1922, p.p. 92 and ff.

12. Prussian Business Tax by Hill [*Q.J.E.* 1893. pp 77 and ff.]

13. H. C. Adams: Tendencies in railway taxation (*Publications of the American Economic Association*, third series, vol. VI, pp. 281-309,

14. *Ibid*, p. 284.

industrial quality of this excess or surplus value? Do the principles of equity and justice which are acknowledged to lie at the basis of taxation require the taxation of this value in a peculiar manner?" Were competition or government able to keep down the price of the service of transportation to the cost of service rendered, no excess value could exist. "The important fact is this, that a portion of the surplus value now enjoyed by railway corporations is a direct contribution from the public, and that competition is incapable of diffusing this value through a reduction of the price of their service. It is a socially produced value."[15] "It follows without question," added Adams,[16] "that the underlying principle of the financial system of the future will be a recognition of a joint proprietorship between the public and the corporations in all cases where surplus value proves to be a permanent feature." He further pleaded not only for the regulation of prices but for taxation so as to extinguish any surplus value. In fact, an expert commission was instituted to recommend a fair return to investors in pneumatic tube service and it recommended a maximum of 14.2 per cent and minimum of 11.2 on invested capital including interest, profit for risk, renewals and taxes payable.[17] The proposal was not adopted but it was recognised[18] by the taxation expert of the American Treasury during the First World War as a precurser of the excess profits tax introduced in America in 1917.

Wisconsin

In 1911, the American State of Wisconsin levied a tax[19] which, though called an income tax, was, in essence, a profits tax. It originated in an effort to find an equitable and efficient method of personal taxation and applied to businesses as well as individuals.

15. *Ibid* p. 289.
16. *Ibid* p. 290.
17. *Ibid* p. 304.
18. *Q. J. E.* 1921, p. 365
19. *House Journal* 1863, p. 274 *J. P. E. op cit.*

The former were treated as business units, the stockholders being personally exempted from taxation; incorporated concerns paid according to a special tariff graduated, not in accordance with the amount of net income, but in accordance with the earning power of the corporation, while individuals were taxed according to the amount of their income. The rate on business units varied from 5 per cent of the return if the income was less than one per cent of the investment to six per cent if it was eleven per cent or more of the investment. Elaborate, though insufficient, provision was made for depreciation, losses, etc. The tax, however, roused little enthusiasm but great opposition especially from business quarters. This is not to be wondered at in view of the feelings aroused by the excess profits tax during the First and Second World Wars. The grounds of opposition were all-embracing. The tax was wrong in principle, retroactive in its operations and injurious in its results. "It is," said the critics, "shifted in the form of prices; it is burdensome and oppressive; it is impolitic in the government to attempt a regulation of trade by legislation."

The First World War

It was, however, during the First World War that the modern excess profits tax originated. Even in its earliest stages the tax was suggested as a tax on extra profits made in consequence of the war.[20] The first excess profits levy was the Stew Tax (*Gulasch*) levied by Denmark, Sweden and Norway, on the enormous profits made by exporters of provisions to Germany. In the United Kingdom, attention was directed to the huge profits of shipping companies and traders in necessaries and this factor was responsible for the demand for a profits tax. In Germany, attention was early called to the gains made by the manufacturers of leather goods and some other raw materials. In May 1915 the free city of Bremen took

20. *Stamp:* The Taxation of Excess Profits Abroad *E.J.* 1917, pp. 26.

the lead in imposing a profits tax, while Hesse was considering its introduction, and in July Saxony was thinking of it. Very soon, however, the Central Government itself introduced the tax. In May 1915 the tax was introduced in Denmark and Sweden and a tax similar to it—the Munitions levy—in the United Kingdom; in November, Italy introduced the excess profits tax while in December, Germany followed suit. The systems were not only different in different countries but in points of detail were constantly changed.

By the end of 1916 the tax in one form or another was adopted in many other countries. Thus, Russia, Austria and Canada introduced it in May; Holland, France and Spain in June and July; New Zealand in August; and the United States of America and Switzerland in September.

The United States of America:

In imitation of the munition taxes in the neutral countries of Spain and Denmark and in the belligerent countries, America introduced in the budget for 1917 the Munition Manufacturers Tax, definitely restricting it to a period of one year after the war. The rate was $12\frac{1}{2}$ per cent of net profits exceeding 10 per cent on invested capital but in the very next year the rate was reduced. The tax was discontinued after December 1917 because a full fledged excess profits tax was introduced in the War Revenue Acts. After a great deal of controversy between the two Houses—the House of Representatives standing for the Capital Standard and the Senate for the Income Standard—the former was adopted. The maximum of 9 per cent on invested capital was allowed. The tax rate was progressive and ranged from 20 to 60 per cent. It applied to corporations, partnerships and individuals as well; but in 1918 the tax was confined only to corporations having invested capital and the miximum rate was reduced to 40 per cent. The Revenue Act of 1921 repealed the tax, perhaps, because "of administrative difficulties and possibly also because of an

organised propoganda that appeared to have the unlimited financial backing and moral support of the business of the nation."[21] Anyway, its repeal became a party affair and the Republican legislature abolished it in 1921. Not till 1933, was the excess profits tax on corporations introduced. The latter was 5 per cent of the net income in excess of 12½ per cent on declared capital, while the Capital Stock Tax was 1/10 of one per cent on declared capital value.

In 1935, Roosevelt asked for taxes to prevent unjust concentration of wealth and economic power and Congress increased the rate of the excess profits tax and graduated it as a partial substitute for the graduated Income-tax on corporations. The Revenue Act of 1935 marks, as Blakey comments,[22] a distinct turning point in the use of taxation for the decentralisation of wealth and of business organisation, for social, as opposed to fiscal, purposes. The Revenue Act of 1936, made the graduated Corporation Income Tax a normal tax in addition to maintaining the others including the Undistributed Profits Tax. By 1938, the Excess Profits Tax was one of the six levies on a corporation, viz., a graduated normal Income Tax; a graduated Sur-tax on Undistributed Net Income, the Capital Stock Tax, the graduated Personal Holding Company Penalty tax, the graduated Penalty sur-tax on Corporations and the Excess Profits Tax. The last was based on net income as percentage of declared value of capital stock and was 6 per cent over 15 per cent of that income. In 1940, though the United States of America had not entered the War, increases were made in the rates of excess profits and other taxes, and by the second Revenue Act of 1940 a full-fledged excess profits tax was introduced though it was called the declared value excess profits tax. The tax was applied to corpora-

21. The Revenue Act of 1921. *A. E. R.* 1922, P. 75 ; also P. 106.

22. The Revenue Act of 1935 *A. E. R.* 1935 P. 689

tions only, although the President recommended its application to individuals and members of partnerships. In 1941, the tax rates were increased from a minimum of 25 and a maximum of 50 per cent to 35 per cent and 60 per cent respectively. The Revenue Act of 1945 repealed the excess profits tax as well as the capital stock and the declared value excess profits taxes from January 1946.[23]

The United Kingdom: Very early after the declaration of the War-between November 1914 and July 1915—attempts were made in the United Kingdom to induce the Government to tax profits which had swelled largely by increased prices in articles of common consumption. In the middle of June the Government agreed to introduce a special profits tax and in the next month the Munitions Levy—the most important of a number of special profit-appropriating devices introduced before the passing of the excess profits duty—was enacted. This levy was primarily meant to control and guide the supply of munitions and only secondarily to limit the profits of munition manufacturers. It was finally merged in the general profits tax in 1917. The excess profits tax was introduced by Reginald Mckenna in December 1915 and continued for the next five years. The rate was originally 50 per cent of the excess; it was raised to 80 in 1917-18; reduced to 40 in the next year and maintained at 60 for 1920-21. The Income Standard was used in 80 per cent of the assessments though the Capital Standard was an alternative introduced in order to ensure a fair return on invested capital and applied where the Income Standard was regarded as inequitable. The effective rate of normal return varied in different industries reaching in some 33 per cent on invested capital. Apart from its great success as a revenue measure. the British experiment is unique on its administrative side, the most outstanding and characteristic institution being the 'Board of

23. *P.S.Q.* Dec 1945 pp. 487 and ff,

Referees', set up to decide questions of invested capital, normal rate etc.

Even before the excess profits duty disappeared in 1922 the corporation profits tax was introduced in April 1920 and ran concurrently with the excess profits tax. The upper and lower limits of the former were 10 and 5 per cent respectively. But the rate was reduced from 5 to $2\frac{1}{2}$ per cent in June 1923 and the tax itself was abolished in 1924. Not until 1937 when the growing Nazi menace demanded increased expenditure on armaments were profits affected in a special way. The National Defence Contribution was a graduated tax on business profits above a minimum. Progression depended on the ratio which the profits bore to the invested capital. The exempted minimum was either six per cent of the capital or the average profits of 1933-35. The violent opposition to it led to its modification in June 1937, when the tax payer was given the choice between different bases; elasticity in the standard rate between different classes of industry was introduced and the tax was levied at a flat rate. The conscription of man power in 1939 led to the armaments profits duty which was more a sop to public conscience rather than a determined fiscal instrument. Although it was not collected at all as it was very soon replaced by the excess profits tax which covered the widest range of industry and finance, the armaments profits duty recognised not only that excess profits should be subjected to heavier taxation than normal profits but also a new purpose of taxation which was neither revenue nor restrictive but political. The armaments profits duty was to run for three years from the 1st of April 1939 and the rate was to be 60 per cent of the excess. But the War in September led to this duty being replaced by the excess profits tax offering both the Income and the Capital Standard varieties as alternatives. The standard rate varied with a minimum of six per cent. The rate of the tax was 60 per cent of the excess. The tax was criticised in many respects and conse-

quently certain changes were introduced in the Budget of 1940-41. In May 1940 a Dividend Limitation Bill was brought in in order to prevent increased purchasing power reaching the hands of share-holders, but the bill was withdrawn in the next month when the excess profits tax was raised to one hundred per cent, at which rate the tax held good till 31st Dec. 1945 when it was reduced to 60 per cent. The tax was repealed from April 1946.

Tsarist Russia is an extreme example of a country where the system of taxation was generally mediaeval.

Russia

But in respect of the profits tax, she appears to have been far in advance of other nations.[24] It was a graduated tax on industrial profits and their growth since 1898 and was computed on the base of capital stock. In 1906 the general rate of tax was raised and those on higher profits brackets steeply graduated, though the rates were comparatively mild. Profits from 3 per cent to 20 per cent on capital stock were taxed on a sliding scale ranging from 3 per cent to 14 per cent on the amount of profits. Profits above 20 per cent on capital were taxed 14 per cent on all net profits plus a surcharge of 10 per cent on the portion over 20 per cent. The highest rate of tax was 24 per cent. In 1914 there was a blanket increase of 50 per cent on the 1906 schedule and the ceiling was put at 30 per cent of the net profits.

The war profits tax, however, had one of the shortest lives. The Government did not adopt any special financial programme during the first year and a half of the war, although it admitted the need for "the modification of our system of taxation in such a manner as to enforce, as between the various classes of the population, the principle of equality in the distribution of the burden of taxation."[25] In May 1916,

24. Theodore Cohen ; War time profits of Russian industry (1914-16) *P.S. Q.* 1943 PP 217-38

25. *Russian Public Finance during the War*, P. 147 Carnegie endowment series 1928

were introduced the income and war profits taxes under the name "Provisional Tax on excess profits of industrial professions." Instead of making the income and profits taxes, the foundation of the fiscal system, the Russian Government regarded them as subsidiary taxation and as purely financial. The Russian government was not trying to abolish abnormal war time profits. It wanted "to maintain a profit incentive sufficient to make Russian industry want to operate at full speed, and, at thesame time, to tap a lucrative source of revenue."[26] The War Profits tax was justified on the ground that profits had increased unprecedentedly because of the cessation of the import of foreign goods, the increased prosperity of the population resulting from the suppression of the state sale of spirit, the increased consumption where troops were concentrated, and even the temporary disorganisation of the transport service. An interesting feature of the Russian war profits tax of May 1916 was that it combined the Income and Capital Standards in one application,[27] i.e., if profits exceeded 8 per cent of the invested capital and average profits of 1913-14. It applied to individuals in certain professions ; thus the increased salaries of the personnel of joint stock companies, if more than 500 roubles over the average in 1913-14, were taxed. The rates of taxation varied among the different classes of assessees. In 1916, corporations were taxed 20 to 40 per cent on the excess, while in 1917, the tax varied from 40 per cent of the excess if it was 6 per cent on capital, to 80 per cent if the excess exceeded 20 per cent. "The Law of the 12th June 1917 extended the provisions of the measure to the highest officials of joint stock companies by taxing the difference between the pre-war and current salaries." [28] The revolution of 1917 put a stop to further modifications in this tax.

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26. Cohen ! *op. cit (P. S. Q.* 1943 P. 230) Cohen gives the tax yield from 183 firms as 4. 9. million roubles in 1913-14 and 75 millions in 1915-16.

27. Russion Public Finance during the war pp. 201 ff.

28. *Ibid*

Germany:

In Germany, on the other hand, the excess profits tax was a major source of war revenue. With characteristic German thoroughness, the Government had already equipped itself with a census of the distribution of property before the War. In December 1915, profits were blocked. Companies had to invest in Government loans 50 per cent of the excess of current profits over the 5 year pre-war average. "It was a kind of preliminary lien on profits; a large proportion of the excess was first blocked and then later on when the proper calculations had been made a proportion was definitely taken in tax".[29] Germany largely adopted the Income Standard and taxed the excess over the average profits of 1910-14. A minimum of excess was tax-free. There was also the alternative, the Capital Standard, with the normal rate of 6 per cent on invested capital, made up of paid up capital and open reserves. There was a double progression based on the ratio of excess to invested capital and on the ratio of total profits to invested capital, so that the rate varied from 10 to 45 per cent of the excess profits. In 1918 the rates were increased to 30 to 60 per cent, while in the next year the minimum rate was raised to 40 per cent. The tax does not appear to have been a great success largely because of the want of a good administrative staff. "The position was made ten times worse by the choice of the special emergency taxes, which imposed the maximum strain upon the collectors of revenue. The perpetual computations of capital and such tiresome complications as the double progression of the Excess Profits Tax, all these things wasted time-invaluable time."[30]

In Nazi Germany, investment bans were imposed by the Cartel Law of 1933[31] and investments in new plants as well as increase in the production capacity

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29. Hicks, Hicks and Rostas *Taxation of War Wealth*, P. 138
30. *Ibid* P. 140
31. F. Wunderlich: Germany's Defence Economy *Q. J. E.* 1938, P. 407

of existing ones were prohibited. The Stock Act of 1934,[32] provided that all concerns distributing dividends of over 6 per cent must for a period of three years pay all such excess profits to the old discount bank which invested the funds and held them in trust for the shareholders. This limtation encouraged investment of undistributed profits. By September 1937, the dividend tax had not only come to stay but deferred profits were to be paid in tax certificates. In 1939 the Nazis introduced a new excess profits *cum* excess income tax with the ostensible purpose of covering the gap in revenue when the tax certificates began to flow back to the treasury. A war profits tax was introduced in that year. The excess was measured from year to year and the rate of the tax was 15 per cent for 1939-40.

France

Even before the period of the 1914 hostilities, the state of French public finances was rather abnormal.[33] The budget did not balance; the fiscal system was archaic; and the general income tax, just voted, had not yet been put into effect. The efforts put forth in France to increase the public revenue were perhaps less vigorous than those put forth in some of the other belligerent countries".[34] The war profits tax was adopted in July 1916, though the Government announced its intentions to levy such a tax nine months earlier. Till 1916 the rate was 50 per cent of the excess over the average profit of 1911 to 1914. A lumpsum exemption of 5000 francs or a normal return of 6 per cent on invested capital or an exemption of 30 times the *patents* or the tax on business licences which the war profits tax replaced, were also alternatives. The rate was increased to 60 per cent for profits exceeding 500000 francs while the law of December 1917 further

32. *Ibid* p. 408

33. Bertrand Nagaro: *The effect of the war upon French Finance* (Monograph in *Effects of the war upon French Economic Life*: edited by Gide, Carnegie Endowment series 1923, p 77)

34. *Ibid* p. 80.

increased the progression by taking the maximum to 80 per cent of the excess where profits exceeded half a million francs. The tax held good till the end of 1919.

In 1935,[35] a tax of 20 per cent on armament profits was introduced, and in 1939, the tax was extended to other industries with the object of cutting down profits, which were not due merely to increased output. In 1940, the profits limitation tax was introduced and industry was divided into war and non-war industry. In the latter, the tax rate on profits reached 100 per cent, while in the former average pre-war profits or turnover multiplied by pre-war rate of profit, was exempted.

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35. Hicks *op.cit.*

CHAPTER II

The Theoretical Basis

Like the capital levy, the abnormal or excess profits tax has aroused great opposition. "We have not yet found", wrote T.S. Adams[1], the American authority, quarter of a century ago, "a sound theoretical basis for the tax", and remarked[2] that the tax was by nature adapted only to periods of war and inflation and that the determination of normal profits as a percentage of capital was wrong in theory. Carl Plehn, a determined opponent of the levy, condemned it as follows:[3] "As a permanent tax, the excess profits tax sins glaringly against each and all of Adam Smith's famous canons of taxation. (1) It is *not* uniform; (2) It *is* arbitrary; (3) It *is* most inconvenient in form; (4) It *does* take or keep more money out of the pockets of the people than it brings into the treasury. As a tax for one year levied without notice on war profits of a preceding year such a tax has some merits. But as a permanent tax or even as a twice repeated tax an excess profits tax is without social or fiscal justification. Even as a one year expedient it must to succeed, be sprung like the old countryside surprise party before the victims have time to dress for it." "As a source of revenue in times of peace, even in piping times of peace," added Plehn,[4] "the excess profits tax is a tax that is difficult to justify or defend. But as a war tax it has a few distinct merits. They are merits of expediency, not of justice." The same sentiments were echoed by the Secretary of the American Treasury in his report to

Introductory.

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1. Should the Excess Profits Tax be repealed? *Q.J.E.* 1921, P. 376
2. *Ibid* P. 383
3. Review of *Excess Profits Tax Procedure*, *A.E.R.* 1921, PP. 373—374
4. War Profits and Excess Profits Taxation, *Ibid* P. 284.

Congress in 1919,[5] when he stated that the Treasury objected to the excess profits tax even as a war expedient in contradistinction to a war profits tax and that still more objectionable was its operation in peace times, because it encouraged waste in expenditure, put a premium on over-capitalisation and a penalty on pains, energy and enterprise, discouraged new ventures and confirmed old ones in their monopolies. Quarter of a century later *the Economist* wrote:[6] " The principle of EPT is of very doubtful equity in war time and world be quite outrageous in peacetime."

Thus the criticisms levelled against the tax have been varied. Some of them have attacked the very fundamentals of the tax and denied it any merit in theory at all; and others have been based upon administrative experience in America. I shall, therefore, analyse the tax in its theoretical setting.

FORMS OF PROFITS TAXATION:

The taxation of profits may be distinguished into two major kinds–the normal and the abnormal profits taxes. To the first category belong the corporation profits or income tax and the undistributed profits tax. The former has recently [7] been termed the "normal profits tax", because the older name is regarded as not sufficiently restrictive, especially since the introduction in the United States of America of the undistributed profits tax. " In its original form of the Revenue Act of 1936", writes Kimmel [8], " the undistributed profits tax was imposed as a sur-tax on undistributed earnings and the regular income tax

5. *Q. J. E.* 1920—P. 298.

6. 17th March 1945 p. 334. Also compare pp. 128 ff: *A Tax Reform for a Solvent America* (Committee on postwar tax policy. New York 1945) Buchler (*Public Finance* 1940. p. 542) characterises the tax as " intolerable in times of peace"

7. L. H. Kimmel; The Normal Profits Tax. *Annals* 1921, p. 78

8. *Ibid.*

was designated a normal tax. The term normal profits tax serves also to sharpen the distinction between the taxation of profits as such and the special levies on excess profits."

The Normal Profits Tax

In spite of its new name the normal profits tax is essentially an income tax, especially in so far as normal profits include interest on share capital. In arriving at the normal earnings, adjusted net income is first determined for taxable purposes. This levy, which is better known as the corporation income tax, was introduced in the United States of America in 1913 and in England much earlier. It has been justified on various grounds of administration and of principle. In U. S. A. it replaced the corporation excise of 1909 and so has been regarded as a species of the business tax. But excepting that it is on income from business as contrasted with the personal income tax, the normal profits tax is only a variety of the income tax.

Another variety of tax on profits is the undistributed profits tax introduced in the United States of America in 1936[9]. The raising of income tax rates and the differentiation introduced between corporations, individuals and partnerships regarding higher surtaxes induced corporations to withhold distribution of profits in order to evade taxation and thus to form personal holding companies. Such an evasion to escape new burdens has been systematically attempted by tax-payers, while the taxing authorities have equally systematically tried to counter this tendency by stricter accounting, heavier penalties for evasion and by new taxes. One such was the surtax on undistributed earnings. This " tax without a friend " prevented some undesirable effects of such a corporation policy, which would have freed them from the

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9 Buehler : *The Undistributed Profits Tax.* For a shorter account *vide* Buehler *Public Finance* (1940) pp 544—549.

discipline of the banking system by making them independent of the short term credit and long term capital markets; it enabled them to become investment trusts—effects which would have accentuated the evils of monopoly or oligopoly conditions.[10] But the main purpose of this impost was to prevent receivers of large incomes from reducing their income tax payments through the use of the corporation and to discourage the corporate practice of withholding dividends and thereby reducing the taxable personal incomes of owners of common stock. Thus if the profits were distributed, the stockholder would pay the income tax, and, if they were not distributed, the undistributed profits tax would operate.

The Abnormal Profits Tax

The abnormal profits tax, which forms the subject matter of this study, has certain peculiarities of its own and differs in many respects from the profits taxes noted above and the income tax in general. Better known as the Excess Profits Tax, this impost takes two distinct forms–war emergency profits tax and excess profits tax proper.[11] Each of these was prevalent in different countries at different times but the former has been more popular. Although the term excess profits tax was used indiscriminately to denote both these types, the war profits tax was largely prevalent during the last two World Wars. But in some of the American states, where it was found in the last century, and in its form as advocated by H. C. Adams in the beginning of this century [12] it took the shape of the excess profits tax proper.

Although in some respects they are alike, in

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10. The Revenue Act of 1936(*A. E. R.* 1936, pp. 468 ff) ; also J. G. Smith : Economic Significance of the Undistributed Profits Tax (*A. E. R.* 1938. pp. 305—310).

11. Hicks (*The Taxation of War Wealth*, Chapter V) terms this the High Profits Tax but I have retained the word 'Excess' as it has a special ethical and economic significance, as argued later.

12. *Supra* pp. 5—6

more important ones they differ. These differences relate to the element of time, the basis of the impost and the purpose of the levy. From the standpoint of time, the excess profits tax could be a permanent levy, while the other must necessarily be temporary in character. As soon as a war ends or its after-effects disappear, the war profits tax also is bound to disappear as was the case during the I and II World Wars. The excess profits tax may be made and, in fact, was at one time hoped to become a normal feature of peace time budget and not merely a war expedient. Commenting on the American preference during the 1914 War for the excess profits principle as against the war profits principle, an American writer observes,[13] " Its significance does not lie in the substitution of a deduction of exemption based upon capital, for one based upon income. . . . It represents a deliberate rejection of a pre-war standard in favour of a normal standard. War profits taxes must, it would seem, be short-lived. Au excess profits tax might conceivably become a permanent fixture. . . Base the tax on excess of present earnings and with each passing year the basis of the tax becomes more antiquated, more impossible. Base the tax upon excess over a fair return on the investment, properly measured to start with and with each passing year, the tax may become sounder and more equitable. The government asserts, as it were, a right to share in any abnormal or unusual profit realised by the businessman. This is at once the peculiar promise or the peculiar menace or the peculiar scientific interest of the American excess profits tax, as you are inclined to look at it."

The second difference is found in the basis of the levy. Both are no doubt taxes on profits. But the war profits tax tries to mulct only that portion of the profits which may be regarded as traceable to war conditions. Money inflation, government needs,

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13. *Annals* XXV p. 153

competitive demands by other nations, restricted competition in production and other similar circumstances are specially prevalent during a war. It is well known that prices during war and immediately after, rise more rapidly than the cost of production, which necessarily means unusual profits to the producer. Further, certain special industries such as armament manufacture, which in peace-time are of minor significance, become unusually important in war time and, on account of their national importance, enjoy privileges. Not only will their profits rise but economic activity all round becomes brisk. These unusual gains result from abnormal and social circumstances more than from the superior efficiency of the organiser. It is assumed under the war profits tax that the profits obtained in peaceful times are normal and are determined by the free play of ccmpetition, that they are not the result of abnormal circumstances but are entirely traceable to the economic ability of the producers; and that, consequently, such profits should not be taxed except in the ordinary way. So the war profits tax generally takes the pre-war profits as the standard, and applies the axe to extra profits over and above the pre-war level. The basis, therefore, for the war profits tax is the abnormal profits resulting from war conditions, and the assumption is the normality of the pre-war gains. It is, in fact, a levy on *rising*, not excess, profits. Wherever there is insufficiency of pre-war profit data, as in the case of new industries, an arbitrary standard rate is adopted. In some countries as in the United States of America where the Capital Standard was preferred even when the pre-war norm was available, a new standard rate was created, but such a procedure is out of the ordinary.

On the other hand, the excess profits tax takes a different basis. Whether it is applied to the war and immedately postwar years or is a permanent tax, the prewar profits actually obtained by a producer are not

taken as normal profits. It may be that, in determining the standard, the actual earnings will be an important factor but they will not be the main consideration. How exactly the standard profits should be arrived at is considered later.[14] We might, however, note here that this rate may be related to the actual profits, to the prevailing rate of interest on investments, to wages and the standard of living, to cost of production, to the availability of capital or to the national plan. But the fact is that the excess profits tax regards all profits over and above this standard rate as taxable. In other words, if in peace times a firm is earning more profits than this standard, it is liable to the tax. That the tax is introduced during war is *not because* war profits alone should be taxed but because of other reasons. Thus, while the war profits tax takes the excess over the pre-war profits as taxable and consequently applies essentially to war gains, the excess profits tax arrives at its own justifiable norm and affects all extra gains.

The third point of difference is in the purpose. The war profits tax is levied largely on financial grounds i.e. with the object of raising revenue and of the state receiving either a part or the whole of the extra profits in view of the great financial needs of the state during an emergency. Other objects no doubt may be present; thus, for instance, in 1937 the armament profits duty, which was a fore-runner of the excess profits tax in England, was levied not so much for purposes of getting revenue as for placating the labourers demanding the conscription of wealth to balance the conscription of man power. But such non-revenue objects and especially the ethical purpose of preventing the accrual of large profits have not been at the back of the levy. In the excess profits tax the ethical purpose or the socialistic bias is more important than the revenue factor, and,

14. *Infra* Chapter IV.

like the death duty and the unearned increment tax, it has perhaps a greater social significance than a purely fiscal one. The tax is based upon the idea that a person has no right to get larger profits than the norm. It could be used, when levied permanently, as an instrument of planned investment and development in the country.

THE INCOME TAX AND THE EXCESS PROFITS TAX

The most prominent of all taxes to-day is the income tax from whatever point of view we look at it. As a source of revenue it leads all others, practically in every advanced country. It has been heralded as the justest of all imposts. It has even been regarded as an instrument for attaining social justice. More than all, it is of comparatively recent origin. So great a similarity exists between this tax and the excess profits tax that some writers have regarded the two as identical. The question naturally arises–Is there any fundamental difference between them ?

Prevailing Views

The answer is varied and at least three types may be distinguished. "The tax has been called," observed Carl Plehn,[15] "a variant of the income tax. But its sole relation to the income tax is that it uses a form of income as its base. There is otherwise not even a superficial resemblance." He added that every other tax is based on something regarded as normal and permanent or at least recurrent, and even where there is a regularity of intent, the regulation is designed and thought of as permanent and not transitory. On the other hand, an American Democrat leader who was closely connected with the levy ef the tax in 1917 said[16] : "The difference between the excess profits tax and the income tax is this : The income tax is upon the total net income received from all sources, with

15. *A.E.R.* 1920, p. 214

16. Kitchins reply in the debate on excess profits taxation in the House of Representatives, 1917 *Annals* LXVV 1918 p. 149.

a few certain exceptions. The excess profits tax......is a tax on trade or business including professions and occupations." According to this view, all the difference between the taxes is like that between Tweedledum and Tweedledee—the income tax is on the total income and the other is on income from a particular source, i.e. it is a special or particular income tax. While, therefore, Kitchin feels that the two taxes are fundamentally identical, Plehn regards them as different.

A third view is that held by Seligman. He regards the excess profits tax as a business tax, i.e., a tax *in rem* and not *in personam.* "The objection, therefore, is not valid", he writes,[17] "that because the tax is imposed on profits it constitutes double taxation, in super-imposing one income tax upon another," for the excess profits tax, like the corporation income tax, is a tax on a thing, not on a person. It has the same basis, as the income tax viz., ability to-pay, and is really a species of income taxation—the only difference being in the assessees. Tax the income of a business it is an excess profits tax; tax the income of the individual–it becomes an income tax. A similar distinction is made by Josiah stamp.[18] He distinguishes between the fortunes of a particular trading concern and the fortunes of the several individuals receiving profits from it. The excess profits tax is related to profits before they become incomes and is not directly related to incomes at all.[19] In other words, profits are associated with business and income with individuals. Tax the receipts at the source and before they are distributed we have the excess profits tax: tax the same when they are distributed and are in the hands of individuals, we have the income tax.

None of these views, however, appears to be

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17. *Essays in Taxation* p. 700
18. *Fundamental Principles of Taxation*, P. 66
19. *Ibid* P. 67.

Their Limitations

accurate. The contention that the excess profits tax is transitory and abnormal and the income tax is permanent and normal is a specious argument. For the period of the levy of a tax is immaterial from the point of view of the principles underlying any tax. Even the income-tax, by which Chancellors of the Exchequer and experts in theory set so much store to-day as the least unjust and the most productive of taxes, was at one time intended to be temporary and to meet abnormal conditions. The period of levy depends upon the financial needs of the state as well as the political and social environment. Just as the rates of any particular tax may vary from year to year, so also taxes may be imposed or discarded according to circumstances. Further, it cannot be argued that the so-called "excess profits" are an abnormal affair associated with a war or other emergencies. What normal profits are or ought to be is largely a matter of point of view. Thus, pre-war profits may be regarded as normal, as under the Income Standard or a *de novo* normal rate of profits may be legislatively fixed as under the Capital Standard.[20] Moreover, while it is unlikely that in peace times every producer will get extraordinary profits, statistics of profits[21] in India and Great Britian as well as in the United States of America indicate that extraordinary profits are enjoyed by a good number of firms. Lastly, even granting that abnormal profits do not exist, such a circumstance cannot vitiate the principle of the tax. To illustrate, if the income tax is levied on incomes of Rs. 2,000 and above and if in a particular country few receive the taxable income, the income tax does not thereby become an abnormal tax or defective. In short, the crux of the problem of normality depends upon an interpretation of the term "normal rate" of profits.

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20. *Infra* Ch. IV
21, *Infra* Ch. III

Kitchin's distinction is not fundamental. For, the income tax may take many forms. It may be general or partial according as it affects the total income irrespective of its orgin, or only income from a particular source. It may be universal or particular. It may also take the form of the super-tax which affects certain types of incomes above a certain limit or the corporation tax levied on business.

There is a great deal of truth in the suggestion that the excess profits tax is a business tax, but it does not take us far. The corporation tax, the income tax and the super-tax, which are accepted on all hands as income taxes, might also be called business taxes in so far as they affect the income of businesses and not of individuals. Likewise, Josiah Stamp's basis of distinction does not appear to be fundamental. So the essential difference between the income tax and the excess profits tax must be sought elsewhere.

To appreciate the difference we might analyse the characteristic features of the two imposts. The income tax is a tax on net income. i. e. "which comes to the individual above all necessary expenses of acquisition and which is available for his own consumption." Taking this as a workable definition, we find that income is a very wide concept and includes profits, interest, rent and wages from whatever source and in whatever way they are obtained. While it ought to be considered in its *real* aspect, income is, for purposes of convenience, calculated in its monetary form. The basis of the income tax is the principle of ability-to-pay. The least inaccurate test of ability is regarded as income considered principally in its quantitative aspect, though the time, economic, domestic circumstances and economic surplus aspects are also taken into account. The quantitative aspect is expressed in terms of the monetary unit and its multiples. It is assumed that there is a minimum necessary for existence and perhaps for efficiency which must be exempt from taxation, because anybody getting

less than this minimum is "unable to pay" the a tax, excepting at a greater sacrifice to the taxpayer than the accruing benefit to the state. Only those able to pay are taxed, not because they get more than what they ought to, i. e., not because their income is abnormal and, therefore, something to be mulcted, but solely because they have a broader shoulder to bear the burden. Further, we assume that such ability increases with increasing income which is not generally regardcd as undesirable and, therefore, taxable. It only indicates greater ability to bear the tax, Whether such increasing ability is based on the law of diminishing marginal utility or not is immaterial. This ability concept invitably demands the application of the progressive principle. Not only does the *amount* paid increase but the *rate* of taxation keeps pace with faculty. A proportional system of income taxation is condemned to-day, because it is not compatible with the ability-to-pay principle. Income taxation and the progressive principle are inseparable. Moreover, the minimum exempted from taxation increases to some extent with an increase in the size of the family or other responsibility, which might lower the tax-ability of a person. Even the super tax and the corporation income tax are based upon these ideas and consequently are income taxes. In fact, as will be pointed out later, the very justification for the income tax is that it lends itself best to the application of the faculty principle. "By this method alone", observed secretary Hull in introducing the United States income tax in 1913 to Congress, "could every citizen that taxes are being imposed equitably and according to ability to pay."

The next outstanding characteristic of the income tax is the quantum aspect i.e., the tax is levied on the *amount* of income, and the *rate* of income e.g. in respect of the capital invested, or *per capita* in a family, has little significance. Thus, other things being equal a

person who gets Rs. 50,000 a year pays a larger taxboth in amount and in rate than one who gets Rs. 5,000.

Thirdly, the *objective* of the tax is more financial than ethical or social. Wherever it has been levied and ever since the days of Pitt, the income tax has primarily been regarded as a source of revenue- The application of the progressive principle, the variations in the exemption limits and the very principle of ability-to-pay have all been largely determined by the revenue factor. Thus, a higher rate is levied on higher incomes, because that is how the increased burden of taxation can be best distributed, and the increased revenue needs of the state met. It does not, however, mean that the ethical aspect has been lost sight of. In fact, bringing about justice in taxation is itself ethical and the development of the test of faculty from the crude stage of person or poll tax to that of income is trace ableto ethical ideas such as greater equity and juster taxation, and the inevitable, though indirect, reduction in inequalities. As Seligman puts it[22] while the redistribution of wealth must always be a secondary aim compared to the purely fiscal purpose of taxation, progressive income taxes possess the merit of counteracting the tendency towards a greater disparity of wealth. *Nevertheless,* neither in theory nor in practice has the income tax been founded upon an ethical purpose. Thus, the three distinguishing features of the income tax are its ability, quantum and financial aspects.

In some of these features the excess profits tax closely resembles the income tax. Thus, profits are a form of income, and the corporation income tax is levied on income including profits and has been definitely recognised as a kind of income tax. Further, during the First and Second World Wars the excess profits tax was introduced, retained and continued

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22. *The Income tax.*

mainly because of financial considerations. The needs of the state in abnormal times demanded the raising of additional revenue and here were business concerns making abnormal profits which formed a very convenient and easily available source of revenue. In fact, in some recent years very considerable amount of the total tax revenue of the state-? for example, in England nearly a third in 1918 and a sixth in 1943-44 was obtained from the excess profits levy. Further, in a large number of cases the quantum aspect of profits was important. Thus, wherever the Income Standard was adopted—and this was done eventually wherever it was favourable to the assessee—the excess of the amount of profit over the pre-war level was liable to taxation, in the same way as the amount of income that a person was getting in excess of the minimum exempted was considered for purposes of income taxation. Finally, the principle of ability *was* regarded as the basis of the excess profits tax. Some writers[28] have regarded the degree of excessivity itself as a test of ability.

Differinces between the two taxes

These resemblances are only superficial. For, the differences are fundamental and may be discussed under the heads of purpose, basis and structure. While the income tax is financial in its objective, the primary purpose of the excess profits tax is ethical. That a firm has no right to get more than a certain percentage of profits and that anything in excess of the norm is anti-social and, therefore, must be taxed-is and ought to be the object of levying the tax. In fact, the idea of conscripting abnormal profits to balance the conscription of man power is an example of this. Gaston Zeze and Henry Truchy thus describe[24] the origin of the excess profits tax in France in 1916: "It was natural that the idea of imposing a tax on

23. e.g. Stamp; *Fundamental Principles of Taxation* pp. 63-67.
24. *The War Finance of France* by Jeze and Truchy p. 207 (Carnegie Endowment Series)

war profits should suggest itself to the mind of goverments and be not only received with favour but vehemently demanded by public opinion. War profits are of the nature of rent, in the economic sense of the term; they are the outcome of circumstances. Moreover, bred of the calamities of the nation, amid the bereavements, the sufferings and the impoverishment and the ruin of many, these gains which benefit the few are of an extremely and ostentatiously immoral character." Further, the basis of the Capital Standard, whereby the normal rate of return on invested capital is legislatively fixed, supports the view that nobody has a right to get more than the normal. We might dispute the normal rate of return or the process by which it is fixed, but we cannot deny that the idea of taxing the excess is that the excess ought not to exist and if it does, the state has a right to it. The fact that the whole of the excess was not during the First World War taken away by the state was not due to any question of principle but to administrative convenience and economic consequences. Whether all the excess should be taken as during the Second World War or only a part, depends on the effects of such action on social and economic welfare. Further, the normal rate of profit is exempted *because* the profits are not excessive and, therefore, not anti-social. In this respect the excess profits tax is similar to the tax on unearned increments and the death duty. This point is elaborated later.

Secondly, while in the income tax the amount or quantum of income is important, in the excess profits tax the *rate ot return* is fundamental. It is true that, as administered so far, the amount of the excess has loomed large. But, it has been a misleading principle. To repeat the observations of an American authority,[25] the significane of the Capital Standard adopted in America during the First World War does not lie in the

25. *Annals* 1918 p 153

substitution of a deduction of exemption based upon capital for one based upon income. It represents a deliberate rejection of a pre-war standard in favour of a normal standard. War profits taxes must, necessarily be short lived. An excess profits tax might conceivably become a permanent fixture. Base the tax on excess of presant earnings over prewar earnings and with each passing year the tax may become sounder and more equitable. The government asserts, as it were, a right to share in any abnormal or unusual profits realised by the businessmen. This was at once the peculiar promise, or the peculiar menace or the peculiar scientific interest of the American excess profits tax.

Finally, from the point of view of basis the difference between the income and excess profits taxes may be put as "Ability vs. Excessivity". Since the ability-to-pay principle is regarded as fundamental in taxation, I shall examine the true place of the faculty theory in public finance as a background to the concept of Excessivity. What exactly 'ability' signifies is a matter of dispute among financial theorists.[26] I shall consider three schools of thought represented by E. R. A. Seligman and Josiah Stamp, T. S. Adams, and J. A. Hobson.

"The history of finance", observes Seligman,[27] "shows the evolution of the principal of faculty or ability-to-pay—the principle that each individual should be held to help the state in proportion to his ability to help himself. There has been a progressive attempt to realise the demands of fiscal justice and a more or less conscious tendency to work out the principle of ability to pay." The test of ability have shown historically a gradual development from the person through property and expenditure to product and finally to income. Seligman, however, warns[28]

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26. The differances between the subjective and objective interpretations of ability are unimportant here.
27. *The Income Tax*, p. 4
28. *Ibid* p. 17

that while income is in many respects a better test than any of the other criteria, it is not thoroughly adequate, because no single test of ability can be found which will adjust itself to the varying needs of the individuals. "Income may be supplemented by the other tests of faculty in order to form a well-rounded whole." Seligman believes[29] in different criteria of ability to pay, which should be sought for the individual primarily in the sacrifice imposed, and for the business primarily in the privilege enjoyed.

Josiah Stamp agrees[30] largely with Seligman but regards 'ability' as the important principle from the *standpoint of the individual* as distinct from those of the state and the community. Not only is ability, according to this writer,[31] judged with reference to income but is subject to five tests which are quantitative rather than functional or qualitative. These tests are the quantitative aspect, the time element, the economic or pure income aspect and finally the economic surplus distinction. The last of these is an interesting concept, particularly important in connection with the excess profits tax, and this will be discussed later along with Hobson's idea of 'costs' and 'surplus' and with my *Concept of Excessivity*.

Stamp divides ability into general or ordinary ability and special ability.[32] In the former aspect, tax bearing capacity increases with *total* income. A true measure of ability would view the tax payer in the light of his total circumstances and total income, not only of himself but of his family also. The latter may be regarded as the family or common tax paying ability as contrasted with the individual's ability which has not much consideration for all the circumstances of his family. Wherever the first impact of the tax, its real ability basis is to be judged

29. The War Revenue Act *P.S.Q.* 1918, p. 30;
30. *Fundamental Principles of Taxation* ch. II.
31. *Ibid* pp. 15-16.
32. *Ibid* pp. 61 and 66.

with reference to the individual who ultimately bears the burden. The ordinary principle of ability judges upon a vertical scale of magnitude incomes that are alike in quality, but the special principle judges upon a horizontal scale of similar magnitude, things that differ in quality. Special ability exists quite apart from the question of the total income of the recipient. The peculiar feature of special ability is that it is in the nature of a windfall as in the case of increment value duties, reversion duties, excess profits tax etc. "It is a normal thing to settle a man's ability by looking at his regular income but if something comes along for him which is over and above his ordinary expectations and is therefore 'an extra' in relation to his normal standard of life, especially if it is unexpected or undeserved, such a receipt is supposed to possess a peculiarly high degree of ability."[33] "As a development of modern times," adds Stamp,[34] "one is almost obliged to lay it down as a principle that irregular or spasmodic receipts which are not required or essential to provoke or sustain any economic effort or sacrifice, possessed in the abstract a higher degree of ability-to-pay than corresponding amounts of regular income or capital. Whether this principle can properly form the basis of a practical tax is still a matter of doubt, which the record of recent attempts has not yet set at rest."

This interpretation of faculty has been largely accepted in current financial theory. But the dissentients are many, of whom two demand special attention. One of them T. S. Adams, the well-known American authority on excess profits taxation, interprets[35] ability to-pay very widely, specially with reference to the effects of taxation. "It would spare the infant industry; it would encourage industrial experimentation and would lay the heaviest burden

33. *Ibid* p. 61

34. *Ibid* p. 62.

35. *Annals* 1918. p. 153.

upon those who have been most fortunate." Adams suggests the following tests of faculty : [36]

1. Effect of the tax upon the consumer ;
2. Effect on the tax-payer in his capacity as producer ;
3. Consider the businessman in his political and economic environment ;
4. Take the state and community as silent partners in industry ;

and 5. Consider if the tax elicits the requisite investment of capital.

This view-point is all-comprehensive and similar to Jones' concept of "Economy as the first principle of taxation." [37] If this is what the faculty theory means, there can be little objection to the view that ability-to-pay is not only an important but even the only principle of taxation, because with such a wide and rich connotation, 'ability' or 'economy' can be made to comprise all that is vital in the other principles.

Yet another interpretation of ability-to-pay is associated with J. A. Hobson [38] who accepts the principle as the supreme canon of economy and equity and regards it both as an economic and as an ethical maxim as well as the criterion of sound taxation. A sound tax, according to Hobson [39], must conform to two negative conditions : (1) It must not remove or impair any instrument of or incentive to essential or useful processes of production. (2) It must not remove or impair any essential or useful element of consumption. In other words, the really taxable elements of income are those which have a true ability to bear taxation—must be those that are unnecessary to maintain or promote socially serviceable processes of production or consumption. The

36. *Ibid.*

37. *The Nature and First Principle of Taxation.*

38. *Taxation in the New State,*

39. *Ibid* pp. 9-10.

one condition relates to the origin or sources of income, the other to the uses to which income is applied. This emphasis on income arises from Hobson's belief that virtually the whole of taxation is deducted from real income.[40] Income is divisible into (*a*) economically necessary payments for the use of factors of production i.e. costs e.g. standard wages, minimum interest etc. (*b*) unnecessary or excessive payments i.e. surplus; e.g. all economic rents of land, whether 'scarcity' or differential, and all interest, profits and other payments for the use of capital, brains or labour, which are due to superior economic opportunities and are not necessary incentives to secure such use, will rank as surplus. All forms of surplus have a full ability to bear taxation, and all taxation should be directly levied upon surplus. 'Costs' have no power to bear a tax, though, if imposed, they could hold it for a time but sooner or later would shift it on to surplus. Such shifting involves waste and damage to production and is frequently made a source of extortion from consumers and it deceives the public by concealing the financial incidence. Surpluses have no ability to reject or shift taxes imposed on them.

Hobson's view of ability-to-pay has been interpreted by Josiah Stamp as only another aspect of his own 'special ability' principle. "This is," writes Stamp,[41] "an extension of the windfall or special faculty principle to which I have already referred, and is quite different in character from what is ordinarily reckoned as ability, dependent on quantitative rather than functional or qualitative tests." This appears to be a questionable interpretation of Hobson. For, the windfall principle refers to a temporary source of revenue and the examples given by Stamp bear this out. They are increment value duties, reversion duties, excess profits tax

40. *Ibid* pp. 65.

41. *Op. cit.* p. 75.

as applied in war times, and war wealth taxation. These are essentially accidental and temporary gains and cannot be permanent sources of revenue. Hobson's concept of surplus, on the other hand, is meant to be the basis of permanent sources of revenue. 'Costs' cannot permanently be taxed but surplus can, since surplus alone represents ability-to-pay. Thus, according to Hobson, surplus is identical with 'ability' and not with 'special ability.'

Recent writers[42] have restricted the ability-to-pay concept to personal taxation. "Ability-to-pay," remarks M.H. Hunter,[43] "is a subjective concept and has to do with personal feelings, sacrifices, utilities, etc. none of which can have any application to a corporation, a business as such, or any other inanimate thing." Other grounds of justification of business taxation have also been put forward.[44]

What, then, is the place of 'ability' in taxation? Is it a universal principle applicable in theory to all taxes and applied in practice to any appreciable extent? From the latter standpoint we find that a good number of current taxes, which have passed muster at the hands of financial theorists, are not based upon the ability idea. Expenditure taxes have really cut themselves away from the faculty principle. We may not agree with Newmarch that in indirect taxation every man has an opportunity to decide the measure of sacrifice that he will make. When asked whether the sacrifice of a washerwoman on her pound of tea was equal to that of the Duke, he is stated to have said that it was no part of the system to readjust the vicissitudes of fortune.[45] Newmarch clearly believed that a tax on tea satisfied all the fundamental

42. *A. E. R.* March 1936, Supplement P. 166; H. M. Grooves: *How shall Business be taxed* p. 52; M. H. Hunter; Shall we tax corporations or business (*A. E. R.* 1936.)

43. *Op. cit,* P. 85.

44. Paul Studenski; Towards a theory of Business Taxation (*J. P. E* 1940) summarises some of these attempts.

45. Stamp. *op, cit,* p. 58.

conditions of taxation and especially that of equality. It does not mean, however, that indirect taxation, because it is not based on ability, should be given up or is bad. For, as I shall point out later[46], the ability principle is not a universal concept, applicable to all taxes and to all the interests involved in taxation.

We might, however, note here that Stamp, while criticising Newmarch's defence of indirect taxation, writes,[47] "If it (indirect taxation) existed by itself it would be very bad, but as a minor part of a general scheme, carefully watched, it can be made to conform roughly to the principle of ability, over an area, which, though rightly taxable, cannot be properly reached by direct taxation. Direct taxation of the poorer classes must be frequent and in varying doses if it is to conform to the short period fluctuating ability of those classes, and such a tax is troblesome to assess and to collect." This new distinction between short period ability and long period ability and the idea that expenditure taxes are justified on the latter type of ability are hard to accept. Likewise, Stamp's plea[48] that when a wider *area of taxation* is considered, expenditure taxes can be regarded as based on ability is also a novel defence in so far as ability is judged with reference not to an individual taxpayer as generally accepted or even to a family but to a community.

Moreover, not only is progression absent in indirect taxation but regression is the characteristic of these taxes. None of the finer tests of ability, namely, that a tax should be progressive and that it must affect total wealth or income and make allowance for family conditions is satisfied by the expenditure taxes.

It is doubtful if some direct taxes also, such as the age-old land tax and the newest death duty, are based on ability. For, the land tax is not only universal affecting every landholder irrespective of

46. Infra p. 40.

47. *Op. cit.* p. 74.

48. *Ibid*

ability but is also not progressive. Moreover, the principles of this levy are conditioned by conjunctural factors. Similarly, the death duty does not appear to be based on ability. A very interesting basis for this tax has been adduced.[49] "According to the principle of faculty or ability-to-pay which is considered to increase progressively with the amount of an individual's resources, it is fair to impose a graduated scale on such inheritance. But to a son, an inheritance is an expectation, to a remote relation, it is rather in the nature of surprise or windfall and windfalls are are considered to possess a special ability to pay. Here we derive the idea of graduation by degree of consanguinity. Again, the remote relationship gives far less prescriptive right to the fortune, and the boon conferred by the state is correspondingly greater. Whether we look at the 'privilege theory' or the 'special faculty' theory, graduation by consanguinity is intelligible." That ability need not depend on amount but on relationship is needed a novel interpretation of ability and makes one suspect a forced attempt at justifying the consanguinity basis of the tax and of graduation. In fact, Pierson frankly admits[50] that consanguinity is a principle different from ability, and that a tax based on consanguinity is not based on ability. Further, Stamp himself gives away the show by recognising the play of the 'privilege' or benefit principle.

From the point of view of theory also, the ability principle is not of universal importance. It is no doubt fundamental from the standpoint of the *distribution of the burden of taxation* i. e. from the individual point of view. To the question "What principles should govern the amount of taxation to be borne by any one individual as compared with that borne by another," the answer is certainly the ability principle. But the individual's is not the only standpoint and,

49. *Social Significance of Death Duties*, p. 22.

50. *Ibid.* p. 23.

as suggested below, certainly not the most important. As Stamp has pointed out [51] there are three participants in the taxation function viz: the individual who pays the tax, the state which collects and spends the revenue and the community whose welfare and the effects of the taxation policy on whom are the most important thing to consider. The faculty theory emphasises only the kind of considerations that will occur to Smith and Jones when they are weighing their respective burdens and criticising the distribution of taxes between them.[52]

There are historical reasons for this excessive importance given to the ability principle. Taxation was for a long time an instrument of oppression and exploitation of the unfortunate masses and merchants by the ruling classes. The history of the Tudors and the Stuarts in England and of the French kings till the French Revolution broke out is well-known. Each social class attempted to roll off the burden of taxation on some other class and since the courtier and the wealthy aristocrat wielded power and influence or could otherwise purchase immunity, the inevitable result was that the poor were made to pay for the luxuries of the rich. It is to this kind of injustice, oppression and exploitation that most of the revolutions in the world could be traced. In addition to the misuse of the tax power by the rulers, a second factor, which led to the emphasis, almost to the discovery, of the 'ability-to-pay' principle, was the inequality in wealth and income introduced by the Industrial Revolution. The history of the nineteenth century is a history of the few growing richer and the many growing poorer. Thus, the exploitation of one class by another with regard to taxation inevitably gave rise to universality and uniformity of treatment in taxation resulting in the adoption of the proportional system of taxation, while inequality of

51. *op. cit.* pp. 5 and ff.

52. *Ibid* p. 103.

wealth led to the application of the progressive principle. The growing increase in the government need for revenue and the growing democratic influence demanded a new interpretation of the old principles of uniformity and universality. Taxation has always been a burden. How to distribute the existing as well as the growing burden became the problem, and a basis for such distribution was discovered in the ability principle.

It is agreed on all hands that the income tax is is based on ability and, in fact, is the best representative of the faculty principle, but there is conflict of opinion as to the relation between the excess profits tax and ability-to-pay. T. S. Adams believes that the tax is not based on ability, even according to his own broad interpretation of that concept. "If the tax is to endure", he writes,[53] "it must meet the fundamental criticism . . . . that in common with most taxes imposed upon the business unit, it does not conform to the principle of ability-to-pay." Believing that the test of all direct taxation is ability-to-pay, Adams observes[54] that "an income or excess profits tax of any variety is illogical; for its principal incidence and burden are upon the stock-holders; there may be relatively strong stock-holders in weak corporations and very weak stock-holders in very strong corporations. So far as possible we should avoid the intermediary, the agent, the go-between and employ only the personal incom-tax." He associates the tax with benefit by pointing out that, as in a special assessment, no cognisance need be taken of the tax paying ability of the share-holders when excess profiits tax is levied upon a corporation or partnership.[55]

Seligman, however, holds[56] that the tax is based on faculty and not benefit, but he contradicts himself

53. Principles of Excess Profits Taxation, *Annals* Vol. LXXV, p. 151.

54. *Ibid.*

55. *Ibid.*

56. *Essays in Taxation* p. 702.

by introducing [57] an element of privilege and of gains from the environment in connection with the levy. Thus he regards the excess profits tax as a business tax and remarks [58] that 'a business tax is none the less based on ability-to-pay, because the predominant criterion may consist in the profits derived in part from the privileges due to the general economic or legal environment. The excess profits tax is a tax in which as in many others the ability of the tax-payer is measured in part at least by the privileges enjoyed." Thus, Seligman definitely associates the tax with ability but apart from asserting that 'ability' connotes not only the old time consumption or sacrifice element but also the production or privilege element, he fails to explain how profits due partly to the privileges enjoyed by a concern are traceable to 'ability' and not to "benefit".

Josiah Stamp's position is similar, though he thinks that the tax is based on 'special ability'. "The justification for the excess profits duty was peculiarly the special ability principle. [59]" He is, however, doubtful [60] if this principle can be basis of a practical and permanent tax. He further observes "We are still left to consider excess profits as they exist apart from war time, and to ask whether, granted there is special ability, a windfall or lucky recipt, such special ability can be independent of the amount of individual incomes and reside in a corporate or non-personal body," and, elsewhere, [61] he admits that it is not necessarily a good fortune to an individual shareholder viewed in the light of his total circumstances. Indeed, Stamp does not appear to be always sure of the special ability basis of the tax. For he associates the progressive type of excess profits taxation with the faculty principle while he equates

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57. *Ibid.*
58. *Ibid.*
59. *op. cit.* p. 65.
60. *Ibid* p. 62.
61. *Ibid* p. 66.

the proportional levy i. e. at a flat rate, with the benefit concept.[62]

A more recent writer[63] suggests benefit as the basis. " Since the cooperation of society is essential to the succes of any and every business enterprise, whether it be a corporation, partnership or individual enterpreneur, it seems but the part of fairness that business should make some payment to society in return for the part it has played. Here is the logical basis for a tax on business of whatever nature with no consideration of ability. It is a *quid pro quo* payment to society for benefits received."

These conflicting views are traceable to the fact that the excess profits tax has a different foundation altogether.

6 THE PRINCIPLE OF EXCESSIVITY :

An extension of Hobson's analysis of income into 'costs' and 'surplus' inevitably leads us to the principle of excessivity which forms the basis of taxes such as the excess profits tax, the death duty and taxes on increment land value. Income, in fact, can be split up into three distinct parts viz. 'costs', 'normal return', and 'excessive gains'.

Costs are those which are absolutely necessary for replacement, continuation and even increase of factors of production. Thus, they represent the minimum of subsistence and for efficiency of labour, the prevailing minimum rate of interest on capital, and the 'normal' profits of business ability. Even in theory, it is difficult to define accurately what these are, for they are influenced by environmental factors and differ as between different times, countries, industries and professions. In the same country, they differ in booms and depressions and in war and

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62. For other theories underlying business taxation *vide* Studenski: Towards a theory of business taxation (*J.P.E.* 1940); and also articles and discussions in *A. E. R.* 1936.

63. Hunter . *op. cit. A. E. R.* 1936, pp. 86—87.

peace. Theoretically, the cost element is non-taxable and if taxed, the burden would be shifted on 'surpluses', or result in reduced consumption and production. In practice, costs are not non-taxable, because they have a certain unknown amount of squeezability i. e. they can bear some tax burden before the breaking point is reached. It is because of this that many indirect taxes are levied and can be levied, if not with justification, at least, with safety. As Stamp admirably puts it in connection with wages,[64] "The truth is that there are two aspects of 'economic costs', viz. what the worker as a producer will not *offer* his work without and what he cannot go on without; and that in practice, since there is always a margin of wastage in wages inefficiently spent, a wage that in the *net* sum spent efficiently is just a subsistence wage is actually on the *gross* sum received, but not wholly wisely spent, rather *more* than a subsistence wage."

The next class of gain or return is the "normal return" consisting of the gains due to the superior ability of the entrepreneur, the greater desirability of land, the greater efficiency of labour, and the higher productivity of capital—elements which form differential rents–full or quasi. To illustrate, skilled labour and professional classes specially of the higher grades receive an income much larger than the unskilled groups. So long as there are differences in the desirability of factors, the intramarginal elements get a surplus as compared with the cost return that the marginal ones get. This larger income accounts for the higher standards of living consisting of comforts and even luxuries of the wealthy and middle classes. It is something which greater desirability gives rise to and which carries no social stigma of 'profiteering'. A great degree of squeezability is found in such a return and the ability-to-pay concept applies to taxation of this "normal return."

64. *Fundamental Principles*, P. 78.

The third kind of return, which is very important for our present purpose, is the excessive gain giving rise to the 'principle of excessivity'. The excess may be either a capital gain as in death duties and unearned increment in land values, or an income gain as in excess profits. Its essence is that the person who gets this extra has no right to it. It is abnormal in so far as it is something more than what social welfare considers the receiver ought to get and something not traceable to the efficiency of the gainer. The justification for any tax based on such excess is, as a German writer puts it, that the tax is merely the restoration of a part or the whole of a surplus which is never actually the property of the owner but which being socially created is socially owned.

Abnormal gains of this kind arise from various causes. They might be windfalls as in unearned increment in land values. In this case, it is true that any person who with foresight invests in land in a developing locality with the expectation of the value increasing, has a right not only to get interest on the capital invested, but also to share in the increased value of the land. Very often, however, site values shoot up beyond all expectations. Thus land purchased for nominal sums in New York, Chicago and San Francisco a century ago, is now worth thousands of times more than the original price. This gain to the owner is a windfall, to a very large part of which he has no right but to which society has every claim. The increase in the land values is abnormal or excessive.

Likewise, in the case of the death duties, social institutions especially the laws of inheritance and succession are responsible for the devolution of the estate. Unless we assume a 'natural right' of inheritance, a person has no right to the property of another, and the less the consanguinity the greater is the element of abnormality in the inheritance oft property. The property is in the nature of a social gift to the receiver and the death duty is thus based

upon the abnormality or excessivity of the gains. In fact, as Rignano put it,[65] "Consider the levies which the nation makes upon inheritances no longer as *taxes* but as shares in the estate of the deceased devolving upon the nation."

The extra income, gain or 'excess profits'[66] is a price-average cost discrepancy measured by the difference between contractual costs of hired factors and total revenues.[67] As one of its American sponsors put it, it aims at windfalls, fruits of chance and luck, monopoly gains and war profits. "It offers justification for, or at least a partial corrective of, the evils resulting from shipping bounties, customs duties and similar kinds of state aid, by providing that, in case such assistance results in abnormal profits, the government shall share them."[68] Such excessivity is not uncommon in the present day world. Large departments of modern trade, transport and commerce are more combinatory than competitive. A considerable portion of gains is, therefore, in the nature of monopoly revenue i.e. more than the normal return justified under perfectly competitive conditions. Whether such abnormal revenue is due to voluntary or business monopoly or to natural or to social monopoly, the producer gets an income justified neither by his abilily nor by the economic conditions of production; the return is a result of the abnormal and excessive exploitation of the market. It is the social or conjunctural factor that gives rise to it. "Broadly speaking," observes Bain,[69] "there are

65. *Social Significance of Death Duties*, p. 37.

66. There are other varieties of excess incomes but I am confining myself to the most important variety viz. profits.

67. J. S. Bain: Profit rate as a measure of monopoly . . . . (*Q.J.E.* 1941 P, 274). Prof. Bain's valuable and interesting analysis is in some respects open to question which will be discussed in the chapter on 'The Concept of Profits in their theoretical setting.

68. *Q.J.E.* 1921, p. 367.

69. *Q. J. E.* 1941, P. 273. See p. 274 for elucidation of these sources.

three sources of excess profits—lack of freedom of entry, monopoly power in the selling market of the firm, and monopsony in the buying market." Sometimes the extra gain is traceable to war or other abnormal conditions, monetary inflation, protective tariffs, bounties, subsidies and other kinds of state help, foreign demand for goods which are our monopoly, the undeveloped state of the internal market, or similar circumstances. In fact, the basis of the war profits tax is the existence of such excessivity in the war and immediately post war periods.

A study of industrial profits indicates the presence of such excessivity in normal times also, at least in some industries and in some concerns. Granting there are excessive gains, the community's right to them cannot be disputed, for they are in the nature of windfalls. Decades ago, H. C. Adams[70] pointed out that the surplus value of a railway corporation was monopolistic in origin; and that it was a socially produced value, contributed by the public to the corporation and, therefore, jointly owned by the public and the railways. Society has a claim not only to a share of this excess but to the whole of it, though, for reasons of public policy, difficulties in the administration of such a levy, or similar factors, a 100 per cent tax may not be levied except under extraordinary circumstances. And the basis of all such taxation is, thus, not ability but excessivity. It may be suggested[71] that, if there are excessive profits which should be prevented by law, the law would go about the business directly, instead of indirectly by means of a tax. But this view ignores the fact that direct prevention of profits is not always either possible or desirable. For instance, the profits of some concerns dealing in foreign trade, shipping, insurance companies

70. *Publications of the American Economic Association*, third series Vol. VI, pp. 59—60. Also *supra* p. 5.

71. e. g. Fairchild: Suggestions for revision of the federal taxation of income and profits, *A. E. R.* 1920 P. 790.

and similar undertakings are partly contributed to by the foreigner. Direct limitation of profits would help the foreigner and prevent us from benefitting at his expense.

In fact, this concept has already been operating in the super tax which is however, as usual, justified on the ground of "super or special ability." The outstanding feature of this tax is that, above a certain limit, an assessee's income is liable not only to the income tax but also to a sur tax, because that surplus income is excessive and the ordinary rates of income tax are an insufficient burden on it. Even under the existing income tax practice, we can distinguish the three stages described above: *first*, the untaxed minimum or costs, unable to pay; *second*, the income liable to the ordinary income tax with no element of abnormality in it, i. e., able to pay; and *third*, the super tax, representing the excessive income liable to the tax based on abnormality. Primarily because we live in an individualist world and and secondarily because of certain economic repurcussions, the excessive amount liable to the super tax is not actually mulcted 100 per cent.

The determination of the standard rate and of the point and degree of excessivity is indeed difficult, but not more so than in the income tax. "There is no such thing," remarks F. R. Fairchild,[72] "as a normal rate of profits. Profits vary greatly between different kinds of enterprises. All business is speculative, some more, some less. The normal rate of profits, so far as it really exists, is an average rate. In certain years the profits must be higher than such average, in order to off-set the years when profits are small or zero. Even this average is different in different lines of industry. If profits above the normal are in large part denied, capital cannot take the chances of small profits or losses. Large profits indicate large tax paying ability and should be treated accordingly.

72. *Ibid* pp. 790—91.

Beyond this, competitive business conditions may be relied upon to take care of the abnormal profits." This view is inaccurate. The excess profits tax proceeds on the obvious fact that profits differ in different industries and, thus, allows different norms. It is doubtful if the normal rate is, as Fairchild contends, "an average rate"—average of what? Further, there are concerns which continuously and regularly get more profits than the "average rate", and it would be queer logic and certainly poor consolation for the sub-average concerns to know that their low profits have helped to maintain free of tax the high profits of the intra-marginal firms. The experience of the United Kingdom and the United States of America clearly shows that the normal rate can be determined. Finally, actual conditions in the business world indicate how illusory is the belief in the working of competitive forces in profit making. "Competition between industries," concludes Ralph Epstein after a detailed investigation into industrial profits in America,[73] "in no sense brings the reward of the groups of producers......to anything like a common level. These diverse earning rates of different industries cannot be regarded as differention due to the 'rent' of superior business abilities . . . . . . Nor can the element of difference in either 'risks' or uncertainties account for the persistent differentials in earning rates" He adds [74] "The imperfect character of competition the prevalence of trade marks, special designs of products, quasi-monopoly advantages of all sorts—serves also to explain why the tendency towards equality is not realised."

The question of normal profits is, however, an important one and has been discussed in detail elsewhere. [75] But we might note here some factors affecting the rate. Normal profits are dynamic and relative,

73. *Industrial Profits in U. S. A.* P. 582.

74. *Ibid* P. 111.

75. *Infra* Chapter IV.

not static and absolute. They depend upon the conjuncture—differing in different economic environments and as between industries, varying at different times in the same country and in the same industry. They depend upon the structure and orgnisation of production and variations in competitive forces. They vary with risks. They are influenced by the social structure and political ideals. No single norm, therefore, can be fixed for all undertakings, in all areas and for all times. The exempted rate of profits has no reference to the individual but to the business. It is based not on the ground of ability to pay but of inexcessivity. If it were based on the ability concept, it would be inconsistent to regard the profits as unable to pay the excess profits tax but quite able to bear the income and other taxes which are, of course, levied on them, and this would mean that 'ability' differs with different taxes.

In spite of all factors considered and precautions taken, the standard rate of normal profits for any type of business must necessarily be arbitrary. Such arbitrariness, however, is not peculiar to the excess profits tax. Thus, in the best of all the taxes that we have, the income tax, not only is the method of assessing the net income inexact, but more inaccurate and arbitrary is the determination of the untaxed minimum. Even in theory, it is a moot point as to what truly constitutes income and how much should be exempt, while in practice widely differing systems are found. For instance, the amount exempted is Rs. 2500 in British India. In the United Kingdom the untaxed income was £ 150 in the case of a bachelor but the minimum varies with the number of dependents and the type of income. Further, the exempted limit changes with the fiscal needs of the state. These variations depending on countries and times show the arbitrary nature of the income tax. Further, in the same country and the same year, the same amount cannot be sufficient for everybody's physical necessaries even, which vary between persons.

Adequate provision is not made for the differing responsibilities regarding dependents e. g. the size of the family, the health and age of its members, their educational needs, differences in financial encumbrances, etc. Varying conventional and efficiency minima are not and really cannot be accurately provided for. Moreover, no consideration is shown to interest on capital. If interest is a 'cost' necessary to maintain capital, and ability is the basis of a tax, then, a minimum rate of interest must be exempted from taxation in the same way as a minimum wage should be exempt. And the *amount* of interest—not the *rate*—exempted must necessarily vary with the quantum of capital. On the other hand, under income tax practice, discrimination is made *against* such income. Thus, even in the most equitable tax, a great deal of arbitrariness is present. Similarly, in determining the standard or normal profits, i. e. the degree of excessivity and the rate of the excess profits tax itself, arbitrary decisions are inevitable. But as already pointed out, it is possible—in fact, this was achieved in the United Kingdom and other countries–to provide for the various factors affecting these rates. Differentiation and discrimination can be and should be introduced as between different industries and even firms, where social and economic interests demand such a treatment. Elsewhere[76] I have attempted to offer a practical solution of these problems.

Here, however, we might note one more difference between the income and excess profits taxes. In the former tax, differentiation and discrimination are made with reference to the individual taxpayer's ability, whereas in the latter, differences in the treatment of profits refer only to industries as a type or in special cases to individual firms but not with reference to the individual shareholder's or owner's ability, because such differences in treatment are based on social needs.

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76. *Infra* ch IV.

Two peculiarties of the profits tax may be noted first, the importance of the *rate* of profits and, second, the degree of liability of the excess. In the income and super taxes the *amount* of income is considered and there is no criterion for judging the *rate* of income. But the *amount* of profits can never truly represent excessivity under the profits tax. For, profits can have significance only with reference to the investment, among other factors. For instance, suppose there are two concerns 'X' and 'Y' in the same type of industry, with the same element of risk, etc. and each getting a net profit of one lakh of rupees. The capital invested in X is two lakhs and in Y five. The exemption would be inequitable if it were a definite amount instead of a normal *rate* of return. If this rate is fixed at, say, 15 per cent, X would get an exemption of Rs. 30,000 and Y of 75,000 so that the excess liable would be Rs. 70,000 in the former case and only Rs. 25,000 in the latter. The fairness of this arrangement is seen when the rate of profits earned by X and Y is considered — X gets 50 per cent and X 20 per cent only, although the amount of profits is the same. If the exempted amount were, as in the income tax, the same, then X, the firm with a smaller investment, would benefit more and Y would have been inequitably treated with the result that large invesments of capital in any one concern would be discouraged.

Further, the essence of the standard rate is that it is not excessive. It follows, therefore, that all profits above this rate are excessive and are equally liable to taxation to their full extent. There cannot be, strictly speaking, any consideration for differing degrees of excessivity. To illustrate, suppose there are an iron and a textile concern as under :

	Iron	*Textile*
Capital invested	100 lakhs	100 lakhs
Net profit (amount)	50 ,,	15 ,,
,, (rate)	50%	15%
Normal rate exempted	10%	12%

	Iron	Textile
Normal rate as amount	10 lakhs	12 lakhs
Excess as rate	40%	3%
,, as amount	40 lakhs	3 lakhs

Although there is a difference between the two concerns both in the rate and amount of excessivity, they are and ought to be liable, according to the logic of the tax, to indentical treatment in so far as the *whole* of the excess is liable. Under an income tax, where the amount is important, the rate of the tax would be lower on the textile concern. But under the profits tax the state can legitimately claim the whole of the excess, though a 100 per cent duty need not always be levied. For, administrative factors, e. g. evasion, political consequences, e. g. disaffection among the industrial classes ; fiscal considerations, e.g. absence of need of large revenue or economic effects, e. g. the flight of capital, may counsel a lower percentage.

PROGRESSION AND THE EXCESS PROFITS TAX :

If only a part of the excess is appropriated by the community should the proportional or the progressive principle be followed ? In actual practice both have been in vogue in different countries.

Gruduation of the tax has been common. Thus, during the First World War Russia, Denmark, Italy, Austria, U. S. A., and Spain, among other countries, followed it.[77] In Russia, the minimum rate of levy was 20% on excess, and if the profit rate was over 9% on invested capital, the tax rate was 21% ; if over 10% the tax was 22% and so on, with a maximum of 40% tax on profits of 20% and more ; in Denmark 8% on capital ; 10% on excess between 8 and 10%, and so on with a maximum of 20% on profits exceeding 20% on capital. Neither of these countries followed the slab

77. For a short account *vide* Josiah Stamp : Taxation of Excess Profits Abroad. *E.J.* 1917 pp. 34 and ff.

system. Italy and Spain, however, adopted the slab system also.

ITALY †

Tax rate			Rate of profits on capital ‡
12	on the part of profits	between	8 and 10 per cent
18	,,	,,	10 and 15 ,,
24	,,	,,	15 and 20 ,,
35	,,	,,	20 and 30 ,,

SPAIN

25 per cent	,,	exceeding	20 per cent
30 ,,	,,	,,	20 and 35 per cent
35 ,,	,,	,,	35 and 50 ,,
40	,,	over	50 per cent

Slightly differing rates and arrangements were found in Austria, U. S. A. and other countries. In Sweden graduated rates were linked to the *size*, and not rate, of excess.

In theory also differences of opinion are found. "Something can be said", writes Seligman [78] "for a graduated tax on income; something can be said for a graduated tax on capital; but it is difficult to say anything in defence of a tax which is graduated on the varying percentage which income bears to capital." According to Stamp,[79] however, "Progressive taxation of businesses as a whole finds no justification on grounds of marginal psychological sacrifice. But one or two writers have based progression not so much upon the taxpayer's *subjective powers* as upon his *objective capacity*, with the idea of his command over economic resources in general on the productive side." "The *basis of a progressive charge*," adds Stamp,[80] "is not so clear without recourse to some *element of faculty*. As soon as it is decided to relate the excess to a basis of capital or prewar profit before applying a progressive tax, the popular idea as to *special war time ability* to

† Later the tax rates were increased.

‡ Rate of excess excluding the exempted norm.

78. *P.S.Q.* 1918 p. 29.

79. Op. cit. p. 33.

80. *Ibid.*

pay seems to have a chance to operate; but of course, it is as far off as ever from a working principle, because the popular idea is always associated with the principle of sacrifice and with what the fortunate individual can *afford* to pay . . . But when the second kind of relationship, that which compares the excess with the war profit, prevails and the tax is progressive accordingly, we seem to get near to the principle that 'to him that hath shall be given' and 'from him that hath not, shall be taken away even that which he hath.' The potentiality of each group of assets is stereotyped as its prewar results, which are assumed to be what was right and proper in its particular circumstances. There is, however, little to show how far such basic considerations have reallly been responsible in the general systems actually in vogue." Sir Jeremy Raisman, the Finance Member of the Government of India, opposed [81] the slab system in the Indian excess profits tax on the ground that "the principle of graduation may work in an entirely perverse way." One of the latest writers on the tax, J. R. Hicks, considers [82] that the only equitable way of taxing profits is by a general proportional tax and that a progressive excess profits tax is not defensible since the higher excess profits do not necessarily go to richer people.

Hicks' objections fall under three heads: (1) On grounds of equity, a progressive excess profits tax overlooks ability to pay. (2) On economic grounds it is undesirable because progression limits the number of firms paying the higher rate on their marginal profits and because progressive excess profits taxes may affect efficiency. (3) It is undesirable administratively, for "progressive excess profits taxes are always likely to breakdown as inflation develops."

Progression is a modern concept and has become especially important in connection with direct taxes,

81. *Legislative Assembly Debates*, 1940 Vol. II P. 1381.

82. *The Taxation of War Wealth* pp. 38—48.

particularly the income tax and the death duty. The concept has been justified on various grounds, few of which seem to hold good with regard to the excess profits tax. First, there is the application of the principle of diminishing marginal utility to incomes. It is only with the development of the marginal theory that the progressive principle came to stay. Instead of believing with Mc-Ulloch that "when you abandon the plain principle (of proportion) you are at sea without rudder and compass, and there is no amount of injustice you may not commit," modern theorists feel that the faculty principle inevitably demands progression if there is to be justice in taxation. There is also the ethical justification of the principle that it is an engine of social improvement and an instrument for reducing inequalities of wealth.[83] Yet another justification of progression is Hobson's doctrine of surplus.[84] Believing that surplus alone should be taxed, Hobson feels that the surplus elements are more likely *prima facie* to exist in the incomes of larger amount—the larger the income the greater the proportion of it which is rental, not cost,—so that a progressive income tax in a rough way is taxation on the principle of surplus.

Increased productivity has also been a ground for progression since the larger the income, the more it can be tapped without hurt. This is the justification put forward by some for the progressive taxation of business profits on the *capital standard.* Stamp believes [85] that direct taxation of business is the only true way of reaching greater ability on the production side of wealth.

These bases have been criticised by different schools of thought. Thus Robbins [86] attempts to explode the basic marginal theory itself, while Stamp

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83. Taussig . *Principles of Economics* Vol. II, pp. 539 and ff.
84. *Taxation in the New State*, Ch. IV.
85. *Op. cit.* p. 43.
86. *The Nature and Significance of Economic Science.*

criticises [87] Hobson's interpretation. The ethical foundation of progression has been called to question by individualists who believe only in the fiscal purpose of taxation and deny that taxation has any ethical basis at all. We need not pause to evaluate the justifications or the criticisms of the progressive principle in general. There can, however, be no question of associating ability with progression in the excess profits tax, since I have argued that ability is not the basis of the tax at all. All excess is equally unjustified irrespective of the amount or the rate. And I have pointed out that theoretically even a 100 per cent tax on excess is perfectly justified. Further, the ethical basis of progression also is irrelevant since the excess profits tax is itself ethical in its basis, and, therefore, no special ethical justification is necessary for the progressive principle. It is only administrative convenience and productivity that demand the application of progression to profit taxation. It is obvious that a proportional levy yields less revenue than a progressive one. If and so long as progressive rates can be applied and made a success administratively, the excess profits tax should be progressive.

None of Hicks' objections appears unsurmountable. From the standpoint of equity I have suggested [88] how the tax must be looked at from a new social angle and a new set of principles must form the basis of taxation.

The second objection relating to the effects on efficiency is, as explained in detail in Chapter V, met by linking the rate of normal profits to the efficiency of the assessed firm. If the rate of progression is not very steep and if it is, as indicated below, based on the degree of excessivity and applied on the slab system, sufficient incentive can be provided for efficiency.

87. *Op. cit.* p. 44.

88. *Supra* p. 45.

Thirdly, administrative breakdown under inflation may be possible in a temporary tax where the annual profits are assessed. But under a system of averaging of profits and the linking of the price level to the profits level or to the value of invested capital so as to get at the *real* and not nominal excessivity of profits, the burden of the tax under inflation can be eased.[89]

In applying progression the distinction between the *amount and the rate* of excess should be born in mind. Since *the rate of return*, whether of normal profits or of excess is all important in this tax, graduation should be applied according to the degree of excessivity measured in terms of the rate of profits to capital, with the adoption of the slab system as illustrated under. The minimum rate of taxation may be 20 per cent of the excess while the maximum may not exceed 40%, so that progression will be between these two limits. Suppose the standard rate of normal profits for the sugar industry is fixed at 8 per cent on employed capital and the efficiency index of a firm is unity but it is earning a profit of 30 per cent on capital, then the schedule of taxation would be as under :

Rate of profit earned	30 per cent
Normal rate allowed	8 ,,
Assessable	22 ,,
Excess below 5 per cent taxed at	20 ,,
,, 5 to 10 per cent	25 ,,
,, 10 to 15 ,,	30 ,,
,, 15 to 20 ,,	36 ,,
,, 20 and over	40 ,,

With a fair exempted rate, with the effective rate linked to efficiency, the slab system, a moderate rate of taxation and a slow graduation with the maximum rate not exceeding 40% all objections on grounds of equity, effects and administration can be met.

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89. *Infra.* Ch. IV.

THE SOCIAL STANDPOINT IN TAXATION.

The over-emphasis on the faculty principle and the attempts to make ability-to-pay the basis of taxation as a whole are, apart from the historical causes already mentioned, the result of Classical influence on public finance. To the Classical economists and their followers the individual point of view in all economic matters was predominant. A tax was considered to be merely a fiscal phenomenon where the individual in relation to the burden he shouldered was *all important*. All that mattered was the principle that should govern the amount of taxation to be borne by one individual as compared with another. The Classical thinkers failed to realise the narrowness of their point of view. For the ability of the individual is a restricted conception. So long as taxation is a social function and the tax payer is a member of a group or society, his burden and "tax-ability" must be considered in relation to economic effects on society as a whole. Further, no tax or system of taxation is independent of the expenditure policy of the state. The ability-to-pay depends to a considerable extent on the political and social environment in which the taxpayer lives. 'Ability' is a very elusive concept, and, to the extent it exists, is influenced by social and expenditure policies. The faculty theorists emphasised too much the individual as a tax payer.

It was this onesidedness that Josiah Stamp pointed out. One of his main contributions to fiscal scienee is his emphasis on the standpoints of the state and the community. Perhaps even in the celebrated canons of Adam Smith, an individualist can find these points of view, but it is indeed surprising that, not till after the First World War, the other viewpoints were considered by fiscal theorists as worthy of detailed consideration. Of these two aspects of finance, the government standpoint is largely administrative. It is really the community's point of view that is of permanent importance in taxation. I shall quote here

Stamp before laying a new emphasis on this standpoint. "And lastly, they may be looked at from the point of view of the community as a producing or economic society. It is true, of course, that the points which are beneficial to the community, as a revenue collector (Government) or as an economic unit, will generally also react to the benefit of the individual, but the connection is more remote. A project for taxation may satisfy all conditions of equity to the individual, but it may fail to meet the requirments of revenue, because it is impracticable or wasteful or politically inexpedient. It may even pass the first two barriers successfully but breakdown, because it is hurtful to the economic life of society. Most taxes in practice represent the best practical compromise between the three standpoints that can be arranged in the particular circumstances of the time."[90]

But we should regard the community not merely as a producing unit but as a consuming and distributing unit also. In fact, that is where Stamp does not go far enough. He considers the immediate economic effects as more important from the country's standpoint and ulterior objects as secondary. So long as only the fiscal purpose of taxation is considered, Stamp's viewpoint may be justified but since taxation has a social purpose also, ulterior objects are equally, if not more, important. The true function of taxation, as Hobhouse said, is to secure to society the element of wealth that is of social origin.

For, the test of a tax as of any economic or social activity is its ability to maximise social welfare. While it is true that the application of the ability principle increases individual welfare which forms a part of communal welfare, very often the individual point of view must give way to social considerations. If a tax increases social happiness and if its economic effects add to communal good more than what they take away from it, we might call this the point of

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90. *Fundamental Principles*, P. 5

view of economy. The term 'economy' is used here, not in the sense in which Jones uses the term, but as equivalent to maximisation of social advantage. It is from this angle that the restrictive activities of the state, especially in public finance, are justified. It is not necessary to defend taxation for non-revenue purposes, for instance on alcoholic liquors, in the roundabout way of associating the levy with ability. Thus, Stamp observes[91] that taxes on alcoholic liquors are one of the few effective ways of reaching the economic surplus element in the wages of the poorer classes and that indulgence in alcoholic liquor is, with many, an evil which the state may well discourage or punish its use by special taxation. "Here again", continues this writer,[92] "you will see the new doctrine of the state right to a dynamic policy is only subsidiary and the taxation can be justified without it. . . . If one could not justify taxation of alcoholic liquors on general economic grounds and had to relay on the new found principle, it would find but poor justification in its actual working out in practice . . . Again, I regard the dynamic or ulterior objects as useful and excellent adjuncts to good pre-existent justifications of this type of taxation." The individualist in Josiah Stamp holds him back from asserting that any tax that conduces to social welfare is good and sound, though not according to the accepted orthodox economic standards. There is no need to regard the ulterior objects as only *adjuncts*, for it is ulterior objects that are really important. Public finance, especially taxation, is merely an instrument in achieving economic welfare which itself helps the realisation of social advantage. Consequently taxation is dominated by social objectives.

From this viewpoint three principles of taxation may be indicated,–ability, restrictivity and excessivity. Ability holds good from the individual

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91. *op. cit* p. 194

92. *Ibid.*

point of view and is the test for *an equitable distribution of the burden of taxation between individuals.* Such equitable distribution is itself often a conducive agent towards maximisation of welfare. But, it becomes a secondary principle where social interests demand inequitable taxation. Thus, for instance, where a tax is levied by itself or at a higher rate on foreign investments and enterprise in a country, with the object of taxing the foreigner more heavily than the native—the policy is quite in opposition to the principle of ability, but all the same a sound one. Consequently we have the second principle of Restrictivity. Where the object of the state is to restrict economic activity in a particular direction, a tax may be levied inequitably and completely disregarding the principle of ability. If, in fact, such a tax is based on the principle of ability, it will vitiate its very purpose. This is the basis of such taxes as restrictive excise duties and protective customs. The third principle of Excessivity has for its object, not the restriction of activity, but first, the appropriation by the community of an excess which does not belong to its receiver, after providing an adequate return for the continuation of the activity, and, secondly, the diversion of investment, enterprise and economic activity in general in directions more desirable to the community.[93]

THE CONCEPT OF BENEFIT AND THE EXCESS PROFITS TAX:

It has been suggested by some economists that the excess profits tax contains, like most good ability taxes, a distinct element of the benefit principle representing the state's share in the profits of private business.[94] "It is not", observes Adams[95], " a tax upon the individual to be judged by the sacrifices which it imposes upon him, but the prior claim of

93. *Infra* Ch. V.

94. *Q. J. E. XXXV* P. 368. *Annals.* Vol. LXXV P. 154.

95. *Ibid.*

the state upon private profits which public expenditure or public misfortunes or the general environment maintained by the state have in part produced. The government's claim to part of the profits, particularly in time of war, is so strong as to justify the statement that the stockholders have no claim on profits until the government has released them. When a special assesment or betterment tax is imposed, no cognisance is taken of the individual's ability to pay. For much the same reason, when an excess profits tax is levied upon a corporation or partnership no cognisance need be taken of the tax paying ability of the shareholders. We must have business taxation because business units, as such, benefit by the activities and expenditure of the government, because they have, as business concerns, differing 'abilities' to pay, because the state cannot wait for the distribution of profits from the business source to the ultimate recipients; and because taxes levied at the business source are far less expensive to collect and far more productive in yield than those levied upon individual partners or shareholders in business organisation."

Apart from the contradiction between his statement that the excess profits tax is an ability tax, though it has a distinct element of the benefit principle, and that, as in betterment taxes, no cognisance need be taken of the tax paying ability, Adams feels that profits generally always, but especially in times of war, are traceable to the benefits from government actions and expenditure and that therefore the state has a claim to a part of the profits.

Much the same view is expressed by Josiah Stamp in these words:[96] "A theoretic basis for the proportional taxation of the excess profit (unrelated to any standads) i.e. at a flat rate, may perhaps be found in the benefit principle if it is postulated that the state and the community during war time supply elements through which excess profits arise and that such

96. *Fundamental Principles*, PP. 66—67

external assistance is unrelated to previous circumstances or to the absolute size of business. Under this conception, the tax element is in the background and the position emerges that the payment is a business expense, a royalty, a condition precedent to the making of profits. It is a payment out of the gross profits before they can become income at all. If excess arises through increased output at original prices, the communal necessities have provided the conditions under which the supply is taken up and a charge is made for supplying those conditions; if the excess arises through higher prices on normal output, the state makes a similar charge. Apart from the rare cases where excess is due entirely to reduced expenses, these two classes or a combination of them cover the field and a proportional charge is at any rate comprehensible on this principle." Stamp's real position is difficult to understand. for, as pointed out earlier,[97] he bases the excess profits tax on the 'special ability' principle while at the same time he implies that the ability principle is applicable to *progressive* profit taxation and the benefit principle to the proportional scheme.

A similar uncertainty of view is found in Seligman who writes[98] that while it is true that excess profits are sometimes the result in part at least of the social environment, they are not infrequently to be ascribed to individual ability and inventiveness and that it is entirely proper that a share of the profits should go to the community.

There are two important differences between Adams and Stamp. The latter attempts to correlate benefit with proportional taxation and not with the excess profits levy as a tax. The benefit basis does not explain the excess profits tax *as such* but only the rate of such taxation or the method of such a levy. The validity of associating the benefit principle with

97. *Supra* P. 33.

98. The War Revenue Act (*P. S. Q.* 1918. PP. 21—30).

a proportional levy may be considerd later. What is relevant now is whether benefit can be the basis of the excess profits tax, and Stamp and Adams are inclined to answer in the affirmative. The second difference between Stamp and Adams is that the former regards the excess profits traceable to benefit as pertaining to war time only. Others also have suggested the benefit basis.[97]

The benefit principle implies that a man ought to contribute to public burdens in proportion to and because of the benefits he receives. "The theory of benefit claims that government must give to each individual a return equivalent to the tax he has paid. If it means anything at all, it means that benefit and taxation must be correlative."

Although the concept of benefit is rarely absent *altogether* from most forms of taxation, it has long been abandoned as the basis of justification or measurement of taxation. "It is now generally agreed", writes Seligman,[98] "that we pay taxes not because the state protects us or because we get any benefits from the state but simply because the state is a part of us . . . the principle of benefit would lead us into the greatest absurdities."

The reason for giving up this basis is, as Seligman observes,[99] twofold: first, even if the theory involves a correct interpretation of the relations of the individual to the government, the benefits conferred by government on individuals do not stand in any such relation to wealth–whether to property or to income-as had been imagined. Further, modern political philosophy rests upon the more organic conception of the relation of the individual to the state. Its distinguishing characteristic is the spread throughout the

97. Vide Hunter's observation (*A.E.R.* 1936 PP,86—87) Also Studenski : Government as a Producer. *Annals* 1939. P. 69; Adams: *Proceedings of the National Tax Association* 1917, P 187, etc.

98. *Essays in Taxation* P. 73.

99. *Ibid.* pp. 336 and ff

community of the benefits of good government which make for common welfare. "Where the special benefit to the individual is separately calculable and is no longer a purely incidental result of government action, we are dealing with something that is not a tax at all."[100]

There is, however, some justification in associating benefit with war profits, for a war, which is due to the action of the state, upsets economic equilibrium, and in many ways such as diversion of production into war needs, curtailment of supply, reduction in competition, absence of substitutes and foreign supplies, and creation of monopoly leads to increased prices and increased profits. It is thus possible to argue that both the justification for and the basis of the war profits tax is to a large extent benefit, but this argument is not totally correct nor could it apply to the tax in normal times. For, the same circumstances give rise to increased incomes of various other types such as increased salaries, wages, professional incomes, and higher rates of interest, which must be approached through an excess income tax whose basis will become benefit and not faculty.

The difficulty of basing any tax on benefit is more prominent in peace times. Excess profits may be due to social factors such as legislation of various types e.g. regulation of wages, prices, tariff etc., financial help given by the state, and the growth of demand as a result of increased purchasing power or of population. Or the excess profits may be due to the entrepreneur's skill in reducing costs. The social factors may be regarded as increasing profits by conferring benefits on the producer but we cannot argue that the excess profits tax is justified because of this element of environment and benefit, for the obvious reason that it is not merely businesses or profit-making concerns that benefit from changes in the environment but almost every section of society,

100. *Ibid.* P. 338

and if we try to correlate the excess profits tax with benefit, we shall have to regard the principle of benefit as the basis of every other tax. Thus, we can claim that even an income tax has a benefit basis since the amount of income received by an individual depends to a large extent on conjuncture. Further, it is doubtful if under competitive conditions there is any special benefit from the environment apart from the natural resources and the social factors mentioned above. More than all, the essence of the benefit principle is the traceability of the amount of benefit. The tests of benefit as the basis of a levy are especially present in special assessments and, to a lesser extent, in fees and tolls. The benefit concept involves the three factors of an assessment unit, measurable benefit, and a benefitting class.

Are these found in the excess profits tax? There is an assessment area or unit but no specific act of benefit and no measurable advantage. Consequently, we cannot justify the excess profits tax on the benefit principle but must find out some other basis. The association of benefit with the excess profits tax is probably the result of two factors: first, the importance of the tax during an emergency period and its disappearance after the war as soon as normal conditions return; and secondly, to the confusion between a tax proper and the exercise of taxing power. I do not, however, suggest that there is no element of benefit in the excess profits tax, but I believe that benefit is not the basis of the tax.

CHAPTER III

The Trend of Profits

It is proposed to follow below the trend of profits in India in the inter-war period (1918-39) in order to find out if there has been any tendency towards high profits, and to compare the course of earnings in the United Kingdom, the U.S.A. and India. The object is not to construct in detail any profits index and to relate it to capital.[1]

The profit-earning enterprises

A profit-earning concern may be of many types, both with regard to organisation and with regard to the type of undertaking. In respect of organisation, the enterprise may be public or private. The public or socialist type of business, such as the railways and irrigation projects in India and other types of industrial enterprises in Russia, may earn large profits but, since all their gains go to increase public welfare in the same way as tax revenue does, the study of profits of this type of organisation is irrelevant for our present purpose. Possibly for technical reasons, such as book-keeping, or even for purposes of increasing their efficiency by treating them in the first instance on the same footing as private enterprises, a tax on excess profits or on income of any other type may be levied on government undertakings. Such a tax, however, does not alter the essential characteristic of a socialised business, *viz.*, its existence for public welfare.

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1. This problem is dealt with in another work of mine namely, *Industrial Profits in India* , *vide* also M. H. Gopal : Industrial profits since 1939 (*Eastern Economist*, 12 th May 1944 p 730) same author *: The Trend of Profits -a factual analysis* , same author. The Trend of profits in India (*Sankhya : The Indian Journal of Statistics June,* 1943)

Another type of organisation is the Co-operative one. The profits of these concerns also are not studied hereunder, because both in principle and in practice the co-operative society is of little importance to us. Whatever the benefits of the co-operative movement, its progress in India has been so slow and its ability to make profits has been so little that it may be regarded, at present, as experimental and unimportant from the point of view of taxation of profits. Moreover, in principle, co-operation is oprosed to profit-making and is really a defence against exploitation.

The really important form of organisation from the standpoint of taxation is the proprietory type whose main object is maximisation of gains. Since the excess profits tax is essentially a tax on profits, it is this form of undertaking that must be studied. Proprietory enterprises may be of the single-ownership or partnership or joint-stock type. It is very difficult to get at the earnings of the first two kinds of concerns. A study of the income tax returns would indicate to some extent the gains made by these enterprises. These concerns are, no doubt, numerous in our country and are much more important than in some of the advanced Western countries because the company form of business is yet developing in India. It may also be noted that the most important undertaking in India, and also in other countries, namely, agriculture, cannot be studied for purposes of profits.

Our investigation into the profits made by enterprises in India and elsewhere must, therefore, be necessarily limited to joint-stock concerns in general and mostly of the non-agricultural type.

Difficulties in measuring profits

The object of a profits index is to indicate the trend of profits and to enable long-term comparisons to be made. Profits, however, are one of the hardest kinds of income to measure. Many difficulties are encountered in following them up. To start with, it is difficult to demarcate sharply profits from other types

of earnings.[2] What is meant by profits to-day is something different from what was meant twenty years ago. The most variable among incomes are profits. Business statements relating to income are themselves often inaccurate and it is difficult to determine the extent of such inaccuracy. Moreover, the concerns which are brought under the label 'Joint Stock Enterprise' vary from year to year both in species and in variety. This makes it impossible to stick to an identical sample of enterprises when the profits trend is studied over a long period. Even the *Economist's* index of profits is based on a sample which varies from year to year.[3] Each year's experience, therefore, can only be compared directly with that of the previous year. There is. further, the difficulty about the method adopted for taxation provision by the different concerns. Some companies record the full amount of tax which will be attracted on their latest profits. Others show a sum which is obviously too low to represent the companies' total assessments, but which will be supplemented by tax deducted from shareholders' dividends. The profits figures disclosed to shareholders are subject, before publication, to 'adjustment' by way of allocations from or to unspecified 'internal' reserves, whose effect is to iron out fluctuations in real earning power, to some extent, from year to year.[4] There are other disturbing factors, *e.g.*, differences in the treatment of specific and general reserves and difficulties in knowing at what point the provision of funds for depreciation

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2. For example, compare Lutz's interpretation: "Profit means the accounting approximation of the results of business operation in a particular transaction or over a given period such as a fiscal year. As such, it reveals nothing whatever with respect to whether or not the enterprise has earned or produced income. Income means that yield or fruit or product of the business enterprise which can safely and properly be withdrawn from it without impairing the future capacity of the enterprise to produce income." (*The Business man's stake in Government finance* 1940, quoted in *Annals* 1941 p. 14)

3. The *Economist*. 17th Dec 1938 p. 584

4. *Ibid* p. 597.

begins to take or the character of concealed reserves and hidden profits. Statements of profits are also affected by accounting methods and by the optimistic or pessimistic light in which the future is viewed when the accounts are made up.

"When, on the top of these difficulties, directors are concerned to conceal trade secrets and the ingenuity of accountants is used to hide, rather than to reveal, the true state of affairs, it becomes an impossible task to arrive at any consistent meaning of profits that will apply to a majority of companies in any one year, or even years. The statistician in the present state of affairs, can do little more than throw in his hand and take as his definition of profits what directors, in their wisdom and in their knowledge of commercial and criminal law, choose to declare as such."[5] With these imperfections, however, both of the underlying data and of the statistical technique that has to be employed upon them, a period of twenty years is long enough for drawing comparisions with some approach to accuracy.

Data for United Kingdom[6]

In the United Kingdom and the U. S. A. available statistics of profits do not comprise all types of organisations or occupations. "Where industry is to a considerable extent in private hands or in small units," observes Josiah Stamp[7] with reference to U.K., "the published results of large companies may be wide of the general average. Thus coal mining is about 60% under companies in numbers, but about 95% in profits. Cotton and wool are predominantly company-held, so are iron and steel. But building, timber and printing are predominantly under private management. If the large concerns here sampled tend to be those with greatest fluctuations or if the most fluctuating

5. *Ibid* p. 584

6. The main sources utilised by me are the statements in the *Economist* and the writings of J. C. Stamp, Hargreaves Parkinson and Flux. *Vide* bibliography.

7. *J. R. Stat.* S. 1932. p. 665.

industries tend to be over-represented in the sample, then the sample as a whole will be unrepresentative. I have some knowledge of the relative proportions of the profits of different industries in their aggregate tax assessment, and the proportion in the *Economist* sample can be obtained from the summaries. From this I should say that the groups substantially over-represented in the sample are breweries, oil, tea and textiles, while hotels and iron, coal and steel are undersampled, most of the other groups being roughly of a reasonable order. I find it difficult to conclude that the more flucuating industries are unduly sampled but undoubtedly the large concerns are predominant. But there is no evidence that it is an unfair sample of *large* concerns as such, and the value of the large concerns in the mass of profit is so great that the non-sampling of the small ones at all is of less moment than might appear."

Apart from the books and published statements of the enterprises there are two sources of information regarding profits in the United Kingdom. First, there are the assessments under the Income tax Schedule D. which contains a more or less complete detailed, comparable and aggregated statistics of profits. In addition to the difficulty of obtaining and making up these records, they have certain limitations as representations of actual commercial profits. They are confined to an annual series. Further, income tax allowances for wear and tear are somewhat arbitrary aud do not represent true depreciation and obsolescence. The Inland Revenue figures, moreover, include various trades and professions that are excluded from the *Economist's* returns. Other factors—such as charges in exemption levels, the inclusion of weekly wage-earners in the figures for 1908–09 to 1915–16, the use of the 'link method' to take account of the exclusion of Southern Ireland from the figures from 1922–23 onwards, the assessment, before the financial year 1926–27, of profits on a three years' average, and, above all, that the last

availablc figures are estimated and not actual also serve to stress the rough and ready nature of any gross profits Index based on Inland Revenue figures.[8]

A more easily available, though less complete, account is the periodical statements and indexes of the *Economist*. They have provided 'a unique contribution to economic statistics though the material—owing to the lack of uniform accounting practice—is rarely simple to handle, and is sometimes positively intractable.'[9] In addition to the general disturbing factors mentioned already, there are others to be remembered in this connection. Not only are private traders outside the *Economist's* scope, but a large number of private companies not issuing accounts are also not included in the *Economsit's* tables. Some of the latter are of no small importance. Further, the merger of private companies into public companies adds to the difficulty.

The *Economist's* figures no doubt have a representative sample.

	No. of Companies	Total Net Profits
1908	775	£ 47 m.
1937	2279	£ 281½ m.

The sample e.g., in 1937 was equal to less than ¼ of the total profits assessed for incometax under Schedule D and about five to six per cent of the total national income. The profits exclude debenture interest but include prefernce and ordinary dividends. The data had the same essentials in 1937, *viz.*, ⅔ mainly domestic, about ⅛ to 1/10 commerce and transport and the same proportion of finance as shown below[10] :

8. *The Economist* 17th Dec. 1938. p. 599
9. *Ibid* 6th Jan 1940. pp. 25-26.
10. *Ibid* 17th Dec. 1938. P. 597

TABLE I

Analysis by trades

GROUP	Proportion of years total			
	1913 %	1924 %	1930 %	1935 %
Industry—				
(a) Mainly Domestic :				
Coal, Steel and Engineering ...	15·1	7·0	6·6	10·9
Textiles	*	10·2	2·6	4·1
Food and Drink trades ...	6·6	8·0	11·2	8·8
Public Utilities	5·9	5·5	7·1	7·4
Miscellaneous	(35·8)	34.8	43·1	39·6
Total Domestic Industries ...	(63·4)	65·5	70·6	70·8
(b) Mainly Overseas.				
(Nitrate, Oil, Rubber and Tea) ...	12·1	14·9	10·1	8·1
Total, all industry	(75·5)	80·4	80·7	78·9
Commerce and Transport—				
Retail Trade	*	4·2	5·2	7·0
Communications	14·3	7·9	4.1	4·7
Total Commerce and Transport...	(14·3)	12·1	9·3	11·7
Finance—				
Total	10·2	7·5	10·0	9·4
Grand Total	100	100	100	100

* Not shown separately.

The sample tends towards over-representation of groups like retail trading, food and catering and some branches of the textile industy, and possibly towards the over-representation of steel, engineering and other 'capital goods' trade whose profits are

liable to wider cyclical savings. To some extent, however, this will be offset by the smoothing out effect of directorial adjustments before striking profits. " In short, the limitations of the *Economist's* figures may be summarised as below [11] :

1. The lumping together of home and foreign concerns,
2. The deduction of debenture interest,
3. Variations in the reductions of income-tax in declaring profits,
4. The various terminal dates of accounts,
5. The lag in accounts for holding companies,
6. The influence, in times of violent fluctuations, of the different quarters in which importtant companies may publish their accounts,
7. The disproportionate size of the Miscellaneous Group.
8. There is also, as Stamp points out,[12] a bias of large cases and fluctuating industries and perhaps a certain double counting.
9. The *Economist's* totals do not necessarily reflect true aggregate holdings of earning companies where the latters' subsidiaries make their own reserve appropriations and the parent companies bring on as profits only the net balances which the subsidiaries declare as dividends."

In spite of these limitations the figures afford a picture of earnings in an increasingly reprsentative cross-section of British industry. The following are the types of British enterprises whose profits are studied below[13] :

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11. The *Economist* 30th April and 27th May 1932. Also comments by Stamp and Flux in *J. R. Stat.* S. 1932.

12. *J. R. Stat.* S. 1932.

13. This list, the data and the conclusions relating to British enterprises below are, except where otherwise stated, based upon the quarterly and annual statements in the *Economist*.

1. Breweries,
2. Electric Light and Power,
3. Gas,
4. Hotels, Restaurants, etc.,
5. Iron, Coal and Steel,
6. Canals, etc.,
7. Motor and Cycle,
8. Shipping,
9. Shops and Stores,
10. Tramways,
11. Trust Companies,
12. Telegraph,
13. Land Mortgage, etc.,
14. Nitrate,
15. Oil,
16. Rubber etc.,
17. Tea,
18. Textiles,
19. Waterworks,
20. Miscellaneous.

Data for U.S.A.[14]

Considerable literature is available about American profits and one of the best studies is Ralph Epstein's *Industrial Profits in the United States*. The work is rightly regarded as the best authenticated and largest collection of data concerning the profits of American business enterprises in numerous non-regulated industries. The investigation comprises the incomes and investments of more than 3,000 concerns, large and small; of these 2,046 are connected with manufacturing, 664 with trade, 88 with mining and 345 with finance. The industries cover a wide variety of manufacturing, ten branches of retail and eight of wholesale trade; and mining and quarrying of various types. The period under review is the decade—1919-28—characterised by the post-war boom and depression as well as a normal

14. A good deal of the available and consulted literature is mentioned in the bibliography, but Ralph Epstein's writings have been the mainstay.

period before the Great Depression of 1929. Although a longer series of years would have given us a better view of American profits, a decade is long enough to permit considerale shifts among investments. The sample is perhaps biased in the direction of overstating average profits. "Considerable as is the range of data, they cannot of course be made to reveal the average rate of return upon capital in the United States, except upon the assumption that this average is nearly the same while the investment is made in one industry or the other. That is an assumption more untenable than has been supposed."[15]

The following American industries have been considered;

I. *Manufactures.*—Foods, textiles, leather, rubber lumber, paper, printing and publishing, chemicals, stone, clay and glass, metals and special manufacturing industries.

II. *Trade.*—Retail trade, wholesale trade, and wholesale and retail trade.

III. *Mining.*—Coal, stone, metals, clay, sand and gravel, and miscellaneous.

IV. *Finance.*—Savings banks, commercial banks, national banks, trust companies, and all other finance except life insurance.

Data for India[16]

There do not appear to be any indices of profits for India, nor has any systematic study been made of the problem. The data must, therefore, be sought in the books of the various concerns or their income tax returns or the published statements of the enterprises. The books are for obvious reasons not easily accessible, although they form the most reliable source of information. The income-tax returns are not only less dependable and exhaustive, but suffer from the limitations described above in connection

15. Epstein : *Industrial Profits in the United States*. P . 20.

16. The data have been worked out from the published annual statements of the enterprises. *Vide* for details M. H. Gopal: *Industrial Profits in India.*

with the United Kingdom. In fact, the shortcomings of the income tax returns are more prominent in our country where the income tax law and administration are more imperfect than in Britain. We are, thus, left with only the published statements of the companies. As already pointed out a large number of productive enterprises, such as, agriculture, small businesses, and individual ownership and partnership concerns, must be left out of account. We can, therefore, get at the statements of only joint-stock enterprises.

Of the numerous joint-stock concerns that exist and spring up every year in our country, a large number are of minor importance as business units, although they add to the total *number* of companies. Thus the number of jont-stock banks in 1937-38 was 1,507 but less than 2% of these controlled, like the Big Five in Great Britain, the major part of the business in India. The relative importance of these banks can be illustrated with reference to their capital. In 1937-38 the paid-up capital of the Bank of Baroda and of the Bank of India was Rs. 1 crore each, whereas the Bank of Industries in Bengal had a paid-up capital of Rs. 713 and that of Haliganj in Assam only Rs. 1,250, but all these went to swell the number of banks in the country. The same preponderence of the minor units in the total number of enterprises of a particular class is found in other businesses and elsewhere also. For instance, in the United States in 1932, one sixth of one per cent of manufacturing corporations, i. e. 618 out of 392,000, owned 53 per cent of total assets,[17] while of the total of 48,000 million net profits earned by American business between 1916 and 1921, more than half were earned by a very small fraction of the enterprises.[18] This

17. Krepps: Dividends, interest, profits and wages, 1932-35 (*Q.J.E.* 1935 P. 590.)

18. *Vide* Report of the American Inland Revenue Dept. quoted in *A.E.R* 1922 P. 92.

would give a false idea of the data since the sample, like the one I have considered below, would look less important than it actually is although all the more important concerns are included.

The data for India consist of the profits of most of the important enterprises in the country. Judging from the standpoint of *all* concerns, whatever their importance, the sample represents 13% in 1918 and 5% in 1937. This apparent reduction in the proportion is largely accounted for by the great increase in the total number of companies. Thus the number in 1918 was 2,789 while in 1937 it was to 10,657; the sample contains 351 and 543 companies in the two years respectively. All types of enterprises have been considered, though their relative importance necessarily varies as shown below :—

Proportion of each group to total number in sample

	1918 %	1937 %
Finance	6	6·5
Transport	12	7
Mining	19	10
Manufacture	57	71·5
Miscellaneous	6	6
	100	100

There is an apparent bias in favour of manufactures, but, as the details under this head given below would show, a very large variety of enterprises is included. Further, manufacturing enterprises not only dominate the business world in India but are growing in importance.

The following are the enterprises comprising the major groups in the sample.

India

I. *Financing Institutions.*—

1. Banks,
2. Insurance companies.

II. *Transport and Communication.*—

1. Light Railways,
2. Tramways, Steamer ·transit, & Storage
3. Electric Light and Power, Telephone.

III. *Manufacturing, Mining, Agricultural Industries, etc.*—

1. Paper Mills,
2. Cement, Lime, Pottery, etc.
3. Chemical Industries,
4. Engineering and Metal Works,
5. Flour Mills,
6. Saw Mills, and Timber,
7. Pressing Companies,
8. Sugar Refineries and Distilleries,
9. Oil Companies,
10. Cotton,
11. Jute,
12. Coal,
13. South India Rubber,
14. Real Property,
15. Miscellaneous.

Aggregate profits vs. rate of profits

The net profits of an undertaking may be looked at either as an aggregate or as a rate on capital. The former refers to the total amount earned and is important in the case of income and super-taxes, where the size of the invesment or of the firm or of risks involved is not as important as the size of the income. The essence of the excess profits tax is that there is an excessivity of profits and naturally such excessivity can be better gauged by a study of the rates of profits. If, on the other hand, the *amount* of profits is followed,

certain unforeseen and undesirable consequences may follow, such as the restriction of the size of a firm since the *amount* of profit tends to increase with the size, although the rate of gains may be limited, because of larger investments. A study of the amount must necessarily have reference to various factors such as the capital invested, the type of business, and the size of the undertaking. It should, however, be borne in mind that there are no statistical aggregates of invested capital and as the total invested capital increases annually, the *rate* of return on capital is likely to be misleading. The rate of profits may be looked at either as the rate of dividend on ordinary shares or as the rate of earnings on capital.

Equity dividends and their dependability

"Earnings applicable for dividends", observes Mudgett,[19] "is theoretically the net income after deduction of operating expenses, fixed charges and such reserves as ore depletion. depreciation, repairs, and replacement. But here again these latter charges may be small in poor years and abundant in prosperous years." The equity holders are the real owners and governors of industry and ultimately enjoy the prosperity or endure the adversity of the firm. The preference shareholders are, in a very limited sense of the term, the risk-bearers and the sharers of the fortunes of the concern. Profits applicable to the equity capital are the residuum of residuum and the equity dividends may not accurately indicate the fortunes of the firm. In a few cases, they may represent more than the actual profits made in any particular year while in many others they may not indicate all the gains.

The following figures about the distribution of net profits in England between 1918 and 1938 are interesting:

All the important concerns in the various categories are included under the respective heads.

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19. The Course of Profits during the War, *Annals* 1920, P. 151.

TABLE II

*Distribution of net profits**

(United Kingdom)

	Reserve, etc.	Ordinary dividend	Preference dividend
1918	?	53·7	?
1919	35·1	42·4	12·8
1920	28 9	52·1	14·3
1921	7 8	56 8	27·5
1922	15·2	80·3	21·8
1923	20·3	63·0	19·5
1924	22·3	60·2	19·5
1925	21·1	58·2	18·4
1926	18·0	60·5	18·7
1927	20·7	63·3	18·9
1928	?	60·4	?
1929	20·3	60·3	19·4
1930	13·6	60·4	21·0
1931	15·7	61·2	23·1
1932	5·6	64·8	29·6
1933	8·8	62·5	28·7
1934	17·1	57·0	25·9
1935	20·9	56·2	22·9
1936	24·7	54·4	20·9
1937	27·6	53·7	18·7

* These are the averages relating to twenty types of leading enterprises in the United Kingdom.

It will be observed that the proportion of net profits distributed as ordinary dividend is about 60% though the extremes vary between 42% in 1919 and 80% in 1922. Moreover, different types of concerns set apart different percentages of their net profits for these purposes. Thus shipping has consistently set a very low percentage for ordinary dividends while rubber and gas have distributed a very large portion of the net profits as ordinary dividend.

TABLE III

Proportion of net profits distributed for Ordinary dividends

(United Kingdom) [20]

	Shipping %	Rubber %	Gas %
1918	50·4	61·6	121·6
1919	58·7	68·2	76·4
1920	45·3	84·5	83·2
1921	47·5	66·1	84·8
1922	57·9	196·1	96·3
1923	59·8	93·4	66·9
1924	46·5	83·4	77·4
1925	42·0	84·2	86·3
1926	49·9	80·8	84·7
1927	36·5	80·5	93·0
1928	33·7	71·5	69·1
1929	38·5	72·5	72·5
1930	41·7	71·6	82·7
1931	49·4	83·9	81·9
1932	...	...	84·6
1933	...	...	83·5
1934	38·3	182·6	85·8
1935	16·3	73·3	57·2
1936	18·2	81·9	78·6
1937	16·6	74·7	76·6

20. In cases where the percentage exceeds 100% reserves have been drawn upon.

The practice is not very different in U. S. A. In fact, an American writer [21] regards the reinvesment of a large percentage of the annual net incomes as a very common practice among American corporations. The following figures relating to 1924-28 and to 35 industrial groups of all types involving 874 corporations are interesting.[22]

Percentage of net income reinvested	37%
Highest percentage of net income reinvested (Boots and Shoes)	69·2%
Lowest do. do. (Wires and Nails)	13·0%

A further analysis of American enterprises gives the following results [23] :

Percentage of income paid out in cash dividends

	1924	1925	1926	1927	1928
All manufacturing ...	55·0	50·0	55·0	72·0	65·0
All trade	38·0	39·4	47·3	53·5	48·1

As the following figures show,[24] American industry, after paying taxes, earned between 1921 and 1933 net profits amounting to 62861 million dollars of which 50823 millions were paid out in dividends, i.e. about 80%, though of course the proportion varied in different years.

21. Buchanan: Theory and practice of dividend distribution (*Q. J. E.* 1938-39. p. 75).

22. *Ibid* Table I.

23. *Ibid.*

24. Krepps, *op. cit.* p. 594.

TABLE IV

Net profits and cash dividends

U. S. A.

	Net profits after taxes	In millions of dollars Cash dividend paid
1921	55	2687
1922	4380	2634
1923	5827	3299
1924	4999	3424
1925	6971	4014
1926	6775	4439
1927	5880	4765
1928	7636	5157
1929	8083	5763
1930	1376	5631
1931	3145	4182
1932	5375	2626
1933	2359	2200
Total ...	62861	50821

French experience has not been different as indicated by the following statistics.[25]

TABLE V

Percentage of net profits paid out in dividends

(FRANCE)

Type of Industry	1919	1920	1921	1922	1923	1924	1925	1926
1. Iron and Steel ...	46	67	74	74	79	77	63	70
2. Textiles ...	71	68	57	60	66	66	43	52
3. Chemicale ...	61	64	54	79	74	75	77	76
4. Tools, Machine and metallic construction	49	45	63	53	49	28	40	47
5. Coal	51	54	47	85	69	64	82	92
6. Automobiles ...	....	28	30	25	31	36	43	32
7. Departmental stores	53	118	77	78	67	71	74	....

It is thus obvious that the dividends do not generally over-represent the profits of a concern.

The principles of dividend distribution which guide directorates are many [26]: cash position; fear of illegality, competition and legislation; accumulation of surpluses against possible future losses: stabilisation of dividend rates and share values; special interest of management groups; custom; stability of the concern itself, etc.

There are various methods of hiding profits such as issue of bonus shares, issue of new shares at a fraction of their market value, distributing share holdings in their companies, paying up uncalled capital out of profits, absorptions by other companies at handsome prices, or by means of a large number of shares in another company. In fact, many prosperous concerns very frequently adopt these methods. "It is common knowledge," observed a correspondent of *The Economist*,[27] "that numbers of our largest industrial concerns like the Cunard shipping company have doubled their capital out of reserves and are paying the same percentage on the enlarged capital as a whole." "If all the methods adopted of diminishing the apparent return of the original capital are taken into account," observed another writer,[28] "I am of opinion that nearly half of thc capital invested in our big industries have been provided out of undivided profits". The *Economist* showed [29] how 15 companies with an ordinary capital of thirteen million pounds had by capitalisation of reserves (*i.e.*, undivided profits) increased their nominal capital to over thirty three millions and how, in the biggest of this lot, this resulted in a net profit of 32·6% on the old capital after payment of preference dividend but

26. Buchanan *op. cit.* pp. 78 and ff.
27. 23rd August 1919 p. 320; see also p.313.
28. The *Economist* 16th August 1919 p. 275
29. *Ibid* 23rd March 1918.

became 10·1% on the new capital. According to the same authority, the amount distributed in England (between 1913 and 1919) as bonus shares was £ 23·9 millions, swelling capital from 1,037 millions to 1,061. Without such capitalisation of reserves, the rate of dividend would have risen in that country from the declared rate of 11·2% in 1919 to 11·6%. Further, as Emil Davis points out,[30] "In 1915 the Imperial Tobacco Company's dividend rate on its ordinary shares was 40% free of income-tax; in 1917, it was 22½% and in 1918 16¼% free of tax. A decided fall in the rate of 'dividend' but what are the facts? In 1916 holders of existing 2,78,499 ordinary shares were given one bonus share for every share held; in 1918, they were given one bonus share for every share held: in 1918, they were given yet another bonus of one share for every two shares held, and out of the existing ordinary capital of £ 8,359,872 on which the reduced dividend is paid, not less than £ 5,571,123 are bonus shares. Each such distribution of bonus share is made by capitalising a part of the reserves which automatically increase the amount of the company's capital; hence, other things being equal, each such operation tends to reduce the rate of profit on capital ....Nearly all our big concerns are going in for these distribution of bonus shares and issue of new shares considerably below market value." "I can give," adds Emil Davis, "scores of similar cases." Thus, throughout the I World War, Guest, Keen & Co., one of the great Iron, Steel and Coal concerns in Great Britain, declared a uniform dividend of 15% free of tax and later, it gave each ordinary shareholder one 5% cumulative and tax-free second preference share and two ordinary shares. This involved more than the published existing reserve and was made up from Internal Reserve Fund, whose amount cannot be known. As the *Financial Times*[31] remarked 'This

30. *Ibid* 9th August 1919 p. 238.

31. *Ibid* 30th August 1919 pp 364-365

instance throws an interesting light on the way in which war earnings can be rendered unobtrusive.' Further, the bonus share should be valued not at its face value at which it is given to the shareholder by the concern but what it will fetch in the market. Thus in 1918-19 the Shell Transport Co. of England issued to its shareholders at £ 1 four million new shares the quotation of which was over £ 8. Analysing banking profits in 1943-44, the *Economist* remarked that profits in 1944 were higher but dividends in every case unchanged.[32] "The rise in disclosed profits is a large understatement in the expansion of net earnings."[33] In support of this comment the *Economist* quoted how in 1943 the earnings of the British banks had increased by £ 4 millions and yet the banks escaped EPT, "so that the strengthening of the hidden reserves must again have been very material."

Similarly, in an altogether different way, dividends may be unrepresentative of the true state of the concern. A bank, for instance, cannot afford to show declining profits. During a period of advancing prices unusually great profits are found, whereas in days of falling prices unusual difficulties may come up. If the declared dividends follow faithfully the course of gains and losses, the stability of the concern would seriously be affected. Therefore, secret reserves and Dividend Equalisation Funds are maintained in order to make up the deficiency in the dividend in a particular year. Sometimes dividends may be declared even where no such reserves exist in order to tide over a difficult period or to avoid sudden depressions in the share value or to maintain public confidence in the hope of better days to come. Sometimes a surplus of reserve might also lead to dividends being very much more than the profits of a particular year can justify. The following figures relating to certain types of concerns in the United Kingdom are sug-

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32. *Ibid* 13th January 1945 pp. 56-57
33. *Ibid* 15th Januuary 1944 p. 81

gestive. Gas in 1918 distributed 121% of net profits; Iron, Coal and Steel distributed 102% in 1926 and 122·5% in 1927; Tea in 1920 distributed 151% and Textiles 190% in 1922 as ordinary dividend in addition to paying preference dividend, etc.

It thus follows that the real earnings on the capital and enterprise in any year cannot be measured accurately by dividends—ordinary or preference—actually paid, because the rate of dividend amounts sometimes to more and sometimes to less than the true annual profits. Nor can the true annual earnings be measured even by the balance of the annual Profit and Loss accounts because they often show results which are grossly inaccurate—in consequence of error, sometimes of omission and sometimes of commission—in regard to that factor of annual expense represented by the entire capital outlay on wasting assets.[34]

A further limitation may be noted here. The dividends are declared on the face value of the shares which is often different from their real or market value. The latter fluctuates according to the changes in the declared rates of dividend, the future prospects of the enterprise, the availabily of capital, the prevailing rates of interest, the alternative invesments and similar factors. The capitalisation of the dividend largely determines the real value of the shares. This means that the rate of return on the capital actually *invested* by a person tends to be lower or higher than the declared rate of dividend, and more or less in conformity with the market rate of interest. But from the standpoint of the enterprise and its ability to earn profits, the market value of the shares is not so material as the total capital that is really utilised in running the concern. The capital invested can increase only when there is a real addition to the capital, *e. g.*, the extension of the buildings, renewal and replacement of machinery, etc. Perhaps a premium on the share

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34. *Ibid* 13th March 1920, pp. 601-2

value may help the concern indirectly, *e. g.*, it could borrow on easier and cheaper terms, or a further issue may be facilitated. But the market value of the shares does not add to the invested capital on which the rate of return is determined.

The dependability of dividends as indicative o the trend of profits may be tested by comparing the declared dividend with the rate earned on capital. It is difficult no doubt to define satisfactorily what capital is. But we might follow for the present the definition adopted by the *Economist* and by Hargreaves Parkinson in their formulation of profits indices.[35] They regard capital with reference to which profits are considered, in the legalistic accounting terms, *i. e.*, the paid-up preference and ordinary capital taken at par. "Of the true capital in the economist's sense," observes Parkinson,[36] "employed by these companies there is no measure." "In the long run," he adds, "there is certainly a tendency for accounting capital and true capital to approximate to each other. In the short run, a company's accounting capital is relatively constant and the apparent earnings returned upon it fluctuates mainly under cyclical influences. In the longer run, however, if a company's shares are quoted well below or well above their par value on the stock exchange, its directors will tend either to write off a considerable part of its accounting capital as having been 'lost' or to issue bonus shares which, by watering the capital account, bring the apparent earning power ratio to what is considered to be the 'Norm'. Thus in the long run, accounting capital tends to be based on actual earnings which it may be argued are the best long-term tests of the value of true capital."

The following graph compares the *ordinary dividends declared* with the *profits earned* on all capital and on ordinary capital :

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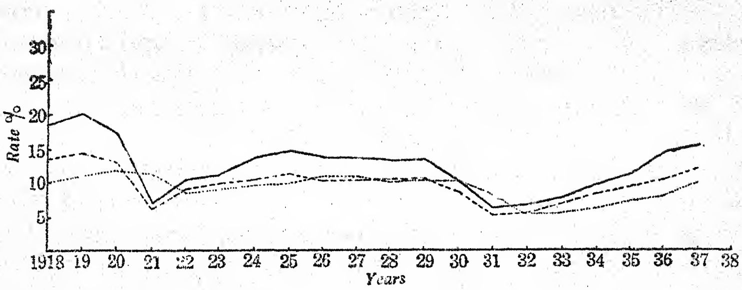
35. *Ibid* 17th Dec. 1938. P. 60,

36. *Ibid.*



GRAPH I. United Kingdom : Rates of Profits, 1918—1937

. . . . = Ordinary Dividends *declared*

———— Profits *earned* on *ordinary* capital

- - - - - - - Profits *earned* on *all* capital

It will be observed that the rate of profits earned on ordinary capital has been higher throughout the period excepting in two years. The same tendency may be observed in the case of of profits earned on *all* capital though in this case the rate earned is naturally not as high as the rate on ordinary capital and in twelve out of twenty years the rate has been higher than the declared dividends and only in three years has it been disinctly lower. Another noticeable tendency is the greater steadiness of the rate of dividends as compared with the profits earned. This is natural in view of the necessary equalisation of dividends in the interests of the concern.

It is, however, plain that the declared dividends on ordinary shares are *generally lower* than the profits earned and may be taken as a safe guide indicating the tendency of profits especially over a long period of uneven prosperity and depression.

PROFIT TRENDS IN INDIA

The three periods

From this point of view I shall analyse profits particularly in India for the last 22 years 1918-39.[37] This period is sufficiently long and sufficiently representative of the ups and downs of prosperity and depression including the decade

35. For profits after 1939, vide M. H. Gopal : Industrial profits sinc 1939. (*Eastern Economist* 12th May 1944 p. 730.)

1925-34 which has been regarded as "an entire trade cycle with about an equal proportion of boom and slump years."[38] The first five years are marked by the business boom consequent on the war which led to the restriction of international trade, the economic isolation of many countries, upsetting of national and international equilibrium and the piling up of huge profits all round, especially in those industries essential for the prosecution of the war. The absence of competition, monetary inflation and the inevitable rise in prices continued for a few years after 1918 and it was not until about 1923 that something like equilibrium and normality in economic life were approached in many countries. One important cause of the post-war boom was the increased demand by consumers to rectify shortages suffered during the war. Indeed, the early months of 1919 afford a remarkable interesting example of the large scale replacement of one kind of demand by another; for civilian demand promptly replaced military needs.[39]

The next seven years (1923–29) were comparatively normal. The gold standard was restored and special deflation was effected in 1925 in the United Kingdom; and monetary stability was approached in many other countries. International trade expanded, isolation gradually tended to disappear and competition, though restricted, increased. The restoration of the gold standard and monetary stability were not perhaps so much the cause of the fall in the abnormal post-war profits as a result of it. The succeeding table (VI) indicates the distinct break in the trend of profits in 1923.

In 1929 commenced the Great Depression affecting all parts of the world and almost all occupations. The adandonment of the gold standard, the growth

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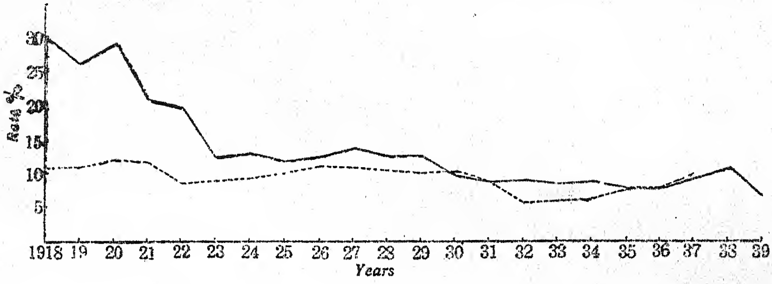
38. Colin Clark: *The Conditions of Economic Progress*, p. 32.

39. *Vide* S. H. Slichter: The period 1919—36 in the United States. Its significance for business cycle theory. (*R.Ec. Stat.* 1937-P. 6.)

of economic restrictionism, the increase in international barter along with a reduction in trade, monetary instability and confusion and the setting in of depression in investment and enterprise stand out after 1929. Although the depression itself tended to disappear about 1933–34, conditions did not become normal till the beginning of the Second World War.

From the point of view of profits this period is broadly divisible into three distinct groups.



GRAPH II. Ordinary Dividends declared
——— = India (1918—1939)
- - - - - - United Kingdom (1918—1937)

I. 1918–22. The period of prosperity,

II. 1923–99. The period of normality,

III. 1930–39. The period of depression and after.

There is no doubt some overlapping of the periods in the case of different types of concerns. Further, in the case of some, *e.g.* jute, the period of comparative prosperity continued right up to 1930. But as indicative of a tendency these three periods are broadly true. Considering industry as a whole the average rate of profits in the first period was 25·1% but the tendency towards a fall in the rate is distinctly noticeable. Many causes contributed towards this decline. The extraordinary conditions of the war period disappeared and normal economic life of the world was emerging. As contrasted with the unevennes of the prosperity period, the steadiness in the rate in the period of normality is noteworthy.

TABLE VI

Ordinary dividends (rate%)

(Average for all types of enterprises)

(India)

1918	30·0	1923	12·6	1930	9·5	Mean	= 13·6
1919	26·0	1924	12·8	1931	8·7	Standard deviation	= 6·91
1920	29·0	1925	12·0	1932	9·1		
1921	20·5	1926	12·5	1933	8·3	Coefficient of variation	= 50·8
1922	19·6	1927	13·5	1934	8·9		
		1928	12·5	1935	7·4		
		1929	12·5	1936	7·6		
				1937	9·5		
				1938	10·8		
				1939	6·5		
	25·1		12·6		8·6		

The average rate for these seven years was half of the preceding period and between 1922 and 1923 the rate fell from 19·6 to 12.6%. This latter rate continued practically steady in the second period until we reach 1930. Industrial production in the twenties increased very slowly and with many vicissitudes, while prices declined sharply. "Rising and falling prices," observes Hargreaves Parkinson [40] "affect profits through changes in inventory values and in the proceeds secured by marking up selling prices by fixed per centage of prime costs. Indirectly they tend to modify business psychology, competitive power in export markets and ultimately the volume of production itself."

40. The *Economist* 17th Dec. 1938 p. 601.

Groups of enterprises

An analysis of the equity dividends of the various groups of enterprises gives the result as in Table VII (*infra*).

It will be observed that, except in a few cases, profits have taken a downward trend since 1918. But this downward movement has not been uniform in all cases. In the case of the first group, *viz.*, banks and insurance companies, excepting in the first few years, say, up to 1924, the fall in dividends has been comparatively slow. But in the second, the fall has notbe en steady. In a few instan ces the fall has been very great. This tendency may have been the result of the general deterioration in trade conditions in the three successive periods, *viz.*, prosperity 1918–22, normality 1923–30, and depression in the following years. In some enterprises such as jute, paper and metal, the post-war years were periods of abnormal profit. The variations in the rate of fall may also be due to the different policies adopted by the concerns in declaring the dividends. The first group—banks and insurance companies—appear to have followed a more balanced policy of distributing profits over a period of years so as to equalise the dividends, unlike concerns such as jute, engineering, cement and paper which seem not to have reserved profits in the prosperous years to equalise dividends in less prosperous ones.

The enterprises distinctly fall into two classes: those which showed a more or less steady course of profits and those whose profits fluctuated considerably. To the first category belong banks, insurance companies, saw mills and timber, electric light and power, telephone, light railways and tramways and to the second, the other enterprises. The rate as well as the degree of steadiness has no doubt varied among the enterprises of the first group but there is a comparative uniformity in the rates declared year after year. Such steadiness may be due either to a deliberate policy of dividend equalisation as, for instance, in the case of financing institutions or to the not highly

TABLE VII

(India, 1918-1939)

	1918	1919	1920	1921	1922	1923	1924	1925	1926	1927
nks	13·4	15·6	16·0	15·1	14·9	15·4	15·4	14·9	14·5	14·5
te Mills	141·5	125·4	109·7	34·8	38·2	39·0	56·8	44·7	36·3	54·2
al Companies ...	15·7	19·0	17·3	18·2	16·8	16·6	16·5	14·5	10·2	8·2
a Companies	19.8	13·6	1·3	11·4	20·0	35·0	36·7	21·7	22·6	34·7
essing Companies ...	...	...	13·8	12·9	12·0	11·3	12·0	14·7	14·5	15·5
l Companies ...	...	...	16·7	9·2	3·1	4·6	2·5	2·5	3·8	5·0
isurance Companies ...	30·0	20·0	25·6	22·5	25·7	15·7	27·1	18·1	15·7	12·8
eal Property and Zamindari	...	...	5·0	32·5	32·5	17·5	3·3	2·3	2·3	2·3
aper Mills	53·5	51·0	51·0	18·8	...	...	...	2·5	8·8	11·3
ement, Lime, Pottery, etc.	32·9	30·5	55·5	54·9	55·0	16·4	6·9	7·6	6·1	7·8
hemical Industries ...	11·5	14·0	11·3	12·8	8·8	7·5	6·2	5·9	6·0	7·2
lectric Light, Power and Telephone	8·8	8·5	7·5	6·8	6·4	5·9	5·6	5·7	6·5	6·6
ngineering and Metal Works	60·1	20·6	24·5	19·8	7·4	4·6	3·0	4·4	3·1	6·0
'lour Mills	...	47·4	46·8	39·5	35·7	18·9	17·1	21·4	19·6	16·4
aw Mills and Timber ...	26·3	30·8	7·9	5·0	7·0	5·0	2·0	4·8	4.4	9·2
ugar Refineries and Distilleries	16·3	15·5	20·3	22·4	14·3	10·6	15·7	9·0	10·3	11·0
ramways, Steamer transit and storage	11·5	13·6	11·7	11·6	9·1	8·2	6·3	7·2	7·8	9·7
Miscellaneous	24·8	19·4	19·0	3·4	10·7	10·2	10·8	9·4	6·5	6·4
South India Rubber ...	...	...	...	...	...	3·8	6·3	25·0	38·1	27·8
Cotton Mills	26·5	40·8	86·9	53·5	46·9	22·7	14·0	10·0	9·3	10·9
Light Railways ...	5·4	5·6	5·9	6·0	5·7	6·1	5·6	6·6	6·3	6·6
Average	30·0	26·0	29·0	20·5	19·6	12·6	12·8	12·0	12·5	13·5

TABLE VII *(contd).*

(India, 1918-1939)

1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938	1939	Average
14·1	13·0	12·2	11·0	10·9	11·4	11·4	7·6	8·8	8·9	...	....	12·7
59·3	41·9	22·1	12·8	10·7	15·6	20·7	14·2	14·1	9·2	5·2	7·1	41·2
7·5	8·8	8·5	6·9	4·7	3·6	3·9	5·0	5·3	5·0	6·7	7·4	10·42
13·8	9·5	5·5	2·7	2·3	9·2	7·8	8·6	10·0	12·6	11·4	....	14·76
14·3	11·3	8·8	11·0	7·7	8·5	8·1	7·6	6·1	4·9	3·2	2·9	10·06
7·5	9·3	8·7	6·7	7·3	4·8	7·5	3·6	2·6	11·8	10·2	7·5	6·7
16·9	13·6	17·1	18·6	17·7	17·7	17·3	17·8	15·1	16·1	14·8	nil	18·17
2·3	5·0	5·0	5·0	7·8	3·8	4·3	2·5	5·5	2·4	2·6	1·8	7·27
21·3	30·0	24·1	24·4	27·6	23·8	25·0	9·7	11·8	8·3	24.1	11·7	19·92
9·9	25·1	23·4	21·5	21·3	23·7	27·2	14·3	10·9	16·0	15·8	16·0	22·66
7·4	7·8	5·5	4·0	5·8	5·4	5·9	5·9	5·9	5·3	....	....	7·49
6·6	6·0	4·9	4·4	4·6	4·9	5·3	5·2	5.4	5·7	5·9	4·1	5·96
6·5	6·0	3·8	2·9	3·6	3·0	5·3	5·4	6·8	14·0	23·6	34·3	12·2
17·6	17·7	6·9	14·1	14·3	1·3	2·4	4·6	9·3	14·8	23·5	2·6	18·62
6·6	7·5	4·0	1·7	3·3	1·7	1·7	6·5	7·3	...	....	....	7·55
11·0	9·8	9·6	11·1	19·5	17·2	11·6	7·2	9·6	3·6	7·9	7·7	12·32
9·9	9·2	7·6	5·2	4·7	5·0	5·7	6·1	5·8	9·1	8·9	6·3	8·18
6·4	5·5	4·9	3·9	3·6	3·6	4·3	5·0	6·6	7·6	7·8	4·4	8·4
6·1	5·3	nil	nil	nil	nil	0·4	2·5	5·0	14·7	7·7	4·6	8·65
10·4	11·4	10·0	9·6	8·8	6·7	8·5	9·8	7·4	9·2	....	....	20·65
6·1	6·2	5·8	4·9	4·6	4·4	4·3	4·3	4·7	4·7	4·8	5·1	5·43
12·5	12·5	9·5	8·7	9·1	8·3	8·9	7·4	7·6	9·5	10·8	6·5	13·2

TABLE VIII

Ordinary dividends

(India, 1918-39)

		1918	1919	1920	1921	1922	1923	1924	1925
	No. of firms	44	46	50	51	52	52	52	52
Jute	Div. above 25%	40	40	40	26	34	35	42	37
	Div. between 15 and 25%	1	1	1	7	2	7	1	4
	No. of firms	67	68	71	75	76	79	81	81
Coal	Div. above 25% ...	15	19	19	18	17	17	18	18
	Div. between 15 and 25%	10	10	10	8	8	11	13	8
	No. of firms	15	15	18	21	24	24	23	23
Cotton	Div. above 25% ...	4	7	11	11	13	9	3	3
	Div. between 15 and 25o/o	4	4	4	2	4	8	8	3
	No. of firms	6	8	11	11	11	12	12	13
Sugar	Div. above 25% ...	1	2	3	3	3	1	1	....
	Div. between 15 and 25%	2	2	2	1	1	2	4	4
	No. of firms	....	7	7	7	7	7	7	7
Flour	Div. above 25% ...	....	6	6	4	6	2	3	3
	Div. between 15 and 25 %	....	1	....	2	....	1	..	2
	No. of firms	11	13	13	14	14	14	14	12
Cement	Div. above 25% ...	2	3	3	4	4	3	1	1
	Div. between 15 and 25%	3	3	4	4	3	3	2	2
	No. of firms	2	3	8	8	7	7	7	7
Insurance	Div. above 25% ...	2	2	4	3	3	3	3	3
	Div. between 15 and 25%	....	....	....	...	..	....	....	....
	No. of firms	18	18	19	22	22	22	23	23
Banks	Dfv. above 25%	1	1	1	1	1	1	1	1
	Div. between 15 and 25o/o	3	5	6	9	9	10	9	6
	No. of firms	....	....	6	6	6	6	6	5
Pressing Coy	Div. above 25o/o ...	....	....	....	....	....	1	1	1
	Div. between 15 and 25o/o	....	....	2	3	3	1	1	2

TABLE VIII

Ordinary dividends

(India, 1918-39)

1926	1927	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938	1939
52	52	53	54	55	55	54	54	54	59	59	59	60	58
29	39	81	41	27	4	3	9	15	17	7	2	....	3
8	3	2	3	8	19	16	16	15	12	14	11	5	6
81	81	71	71	72	72	67	66	66	59	57	56	54	52
10	10	8	10	7	6	5	2	3	2	1	....	4	3
10	6	4	4	6	....	1	4	3	4	6	7	4	8
23	23	21	22	21	22	22	21	17	27	30	28	....	....
2	4	3	3	3	3	3	2	2	2	1	2	....	....
2	1	2	2	1	3	1	1	...	3	4	5	....	....
14	13	13	13	14	14	13	16	19	21	25	26	28	20
1	....	....	....	....	1	5	6	3	1	1	....	1	1
3	6	5	5	4	3	2	2	3	3	4	4	5	....
7	7	7	7	7	7	7	7	7	7	7	5	5	2
2	1	3	1	1	1	1	....	...	1	1	1	1	....
2	2	....	3	1	1	....	....	....	....	....	1	....	....
14	13	13	14	14	14	14	14	13	13	9	7	7	5
1	1	2	2	2	2	2	2	2	1	1	1	1	1
1	1	1	3	2	2	1	3	2	6	2	2	2	1
8	8	9	9	9	9	9	9	6	10	11	9	9	....
3	3	3	3	3	3	3	3	1	2	2	2	2	....
....	....	....	....	....	....	....	....	1	1	1	1	....	....
23	23	22	22	22	22	21	20	20	16	25	25	....	....
1	1	1	1	1	1	1	1	1	....	....	....	....	....
9	9	8	7	7	3	3	3	3	2	3	3	....	....
5	5	5	5	5	5	5	5	5	5	5	5	5	5
1	1	1	....	....	....	....	....	....	....	....	....	....	....
2	2	1	2	....	....	....	....	....	....	....	....	....	....

profitable nature of the enterprise itself, *e.g.*, public utilities such as light railways, electric light and power and telephone. It is surprising how the dividends of the latter group were low even in the period of prosperity. It is possible that *because* they are public utilities, their policy has been less exploitative and the control of the state over them greater, resulting in low profits. In the group with the fluctuating dividends, the degree of fluctuation varies, being highest in jute; but while such fluctuations are inevitable in business, the rate of dividend has been in a good number of cases high.

It may be noted how high the average is in the case of jute, insurance companies, paper mills, cement, lime, pottery, flour mills and cotton mills. In the case of jute, the average for the whole period is 41·2% and even this excessive rate hides the extraordinary average dividend per cent. in particular years. Thus in 1918–20 the rate exceeded 100% and in 1918 passed the 140% limit, while in some other years it easily reached 50%. Likewise, paper, cotton, cement, etc., have in some years exceeded the 40% level, though the average rate has been about 20%.

The preceding study of declared dividends suggests one important conclusion, namely, that in a good number of years in certain types of concerns and in a few years in some others even the average rate tends to be considerably high. But the average is deceptive, since it includes quite a large number of the less fortunate concerns. The excess profits tax, like any other important levy, affects not all concerns but only those which make excessive profits.

The average rate of profits for any group of enterprises hides the phenomenal gains made by some of the individual firms. We might analyse from this point of view some of the leading industries (*vide* Table VIII).

The most striking case is that of the jute industry. Between 1918 and 1930 more than half the number of firms declared dividends exceeding 25% and for

nearly the whole period under review a very considerable number of firms declared above 15%. The average rate of dividends in the jute industry is remarkably high throughout the period. Even if the first three years 1918–20 are regarded as abnormal, the rate has been between 21 and 29, one of the highest averages for any industry. It is hard to imagine that all these profits are traceable to the superior efficiency of the entrepreneur or the greater risk or uncertainty involved.

The prosperous state of this industry is especially noticeable when we analyse the individual concerns according to the rate of dividend declared. In fact, excepting in 1938 and 1939 the number of concerns which declared less than 10 per cent- was smaller than the more prosperous ones. Quite an appreciable number had declared dividends exceeding 50% and a few even 100%. The rate in some of the more fortunate concerns exceeded 300%. The phenomenal prosperity of some the jute mills is indicated by the examples in Table IX.

Some individual concerns.

Very high dividends are also noticeable among coal concerns. The following analysis (Table X) indicates how a considerable number had dividends exceeding 25% right up to 1930 and a few even later. Roughly about 25% declared dividends exceeding 15% for quite a long period. There are a good number of concerns in this industry which have for years been unfortunate enough not to be able to declare any dividends. But as indicated below a few more fortunate concerns have been able to declare very high dividends.

As in the case of jute and coal so also in other industries some enterprises have been making very decent profits as indicated in Table XI.

TABLE IX

Ordinary dividends (rate%)

(India, 1918-39)

Jute Mills

	Names of Mills			
	Gourepore	Hoogli	New Central	Union
1918	250	125	330	275
1919	420	400	125	250
1920	250	200	190	190
1921	20	75	85	nil
1922	70	30	55	50
1923	80	40	60	60
1924	120	100	100	110
1925	60	100	90	45
1926	30	80	40	64
1927	100	100	85	120
1928	60	125	105	115
1929	50	125	75	70
1930	27½	75	30	30
1931	nil	40	20	20
1932	10	20	15	17½
1933	30	20	17½	27½
1934	50	30	20	30
1935	50	30	20	30
1936	40	20	15	22½
1937	22½	10	10	12½
1938	12½	nil	9	8
1939	35	nil	11½	12
Average (1918-39) ...	82	88	68	75

TABLE X

Ordinary dividends (rate %)

(India, 1918-39)

Coal Mines

	Names of Mines				
	Bengal	Bengal-Nagpur	Katras-Jherria	North-West	Standard
1918	55	35	120	50	50
1919	60	60	120	80	80
1920	62½	80	120	80	75
1921	65	80	160	70	70
1922	56	65	145	75	90
1923 ...	57½	85	150	65	85
1924	50	90	110	70	80
1925 ...	40	90	92½	65	80
1926	40	75	60	65	60
1927	40	80	60	40	60
1928 ...	30	60	50	20	60
1929 ...	32½	70	55	25	60
1930 ...	30	75	55	20	50
1931	14	57½	30	8¾	35
1932 ...	11	35	25	....	20
1933	8	30	15	....	15
1934 ..	9	30	15	...	12½
1935	9	6¼	15	nil	22½
1936	12	12½	10	nil	17½
1937	12	12½	11¼	nil	12½
1938	14	nil	....	....	13¾
1939	22	nil	....	....	5
Average (1918-39) ...	33·5	48·5	70	47	48

TABLE XI

Ordinary dividends declared (rate%)

(India, 1918-89)

	Insurance Companies			Sugar		Miscellaneous		Cement, Lime, Pottery			Banks			Cotton		
	Triton	Empire of India	Oriental	Cawnpore	Champural	Ganges Rope	Shivarajpur	Kangra	Kutney		National Bank of India	Hongkong and Shanghai	Allahabad	Bengal-Nagpur	Delhi Cloth	Muir
1918	...	30·0	30·0	25·0	12·0	100·0	20·0	22	12·0	474·3	20	47·2	18	25·0	...	40·0
1919	...	30·0	30·0	40·0	15·0	50·0	20·0	22	27·5	186·2	20	64·0	18	70·0	...	70·0
1920	30	35·0	30·0	60·0	50·0	50·0	40·0	22	15·0	461·7	20	64·0	18	80·0	...	120·0
1921	30	40·0	30·0	70·0	50·0	35·0	50·0	22	27·0	530·6	20	64·0	18	120·0	...	120·0
1922	30	40·0	30·0	35·0	30·0	40·0	30·0	22	30·0	576·7	20	64·0	18	90·0	170·0	120·0
1923	30	40·0	30·0	50·0	10·0	20·0	60·0	22	32·0	75·0	20	64·0	18	30·0	40·0	85·0
1924	40	45·0	30·0	50·0	20·0	40·0	80·0	22	nil	nil	20	64·0	18	20·0	42·0	50·0
1925	40	45·0	30·0	20·0	nil	40·0	80·0	22	nil	nil	20	64·0	18	12·5	32·0	50·0
1926	40	30·0	30·0	30·0	nil	35·0	...	22	nil	nil	20	64·0	18	10·0	40·0	60·0
1927	40	48·0	30·0	20·0	5·0	40·0	30·0	22	nil	nil	20	64·0	18	30·0	22·5	65·0
1928	40	48·0	33·3	12·5	15·0	40·0	15·0	22	11·0	94·0	20	64·0	18	35·0	45·0	55·0
1929	40	49·6	33·3	10·0	15·0	40·0	nil	22	15·0	186·0	20	56·0	18	20·0	50·0	55·0
1930	40	49·6	33·3	7·5	15·0	30·0	7·5	11	15·0	186·0	20	56·0	18	7·5	40·0	50·0
1931	40	49·6	37·5	20·0	15·0	20·0	7·5	6	15·0	186·0	20	48·0	18	15·0	35·0	40·0
1932	40	49·6	37·5	35·0	15·0	5·0	5·0	6	14·0	163·0	20	48·0	18	12·5	35·5	40·0
1933	40	40·0	37·5	30·0	25·0	10·0	5·0	9	16·0	209·0	20	48·0	18	nil	42·5	35·0
1934	...	23·3	62·5	30·0	5·0	12·5	5·0	9	16·0	209·0	18	48·0	18	3·8	48·0	40·0
1935	40	23·3	70·8	25·0	10·0	12·5	5·0	15	16·0	2·0	9	20·0	18	nil	100·0	20·0
1936	40	2·5														15·0
		15·0	62·5	10·0	20·0	15·5	20·0	15	16·0	3·0	18	£5·5	18	nil	40·0	20·0
1937	40	2·0													20·0	7·5
		15·0	62·5	5·0	5·0	12·4	35·0	15	...	...	18	£5·5	18	nil	50·0	22·5
1938	40	3·5														
		13·5	62·5	5·0	5·0	8·0	20·0	15	...	...	...	...	...	...	20·0	...
1939	...	...	...	...	...	8·0	...	15	...	...	...	...	...	...	...	...

The trend of profits in India may usefully be compared with the trend in the United Kingdom and the U. S. A. It must be remembered that the types of enterprises in the different countries are naturally different. Further, while the figures relating to Britain and the U.S.A. include home and foreign profits, Indian figures largely do not.

Trends in the United Kingdom

British investments abroad, which are considerable, yield a higher rate of profit and also fluctuate more than home investments. Thus the highest rate of dividend is found in tea, oil and rubber. "Examination of the record for Rubber and Tea," writes Stamp,[41] "shows clearly that their fluctuations are enormously greater than the general run, while the oil sample shows an aggregate of percentage differences (since 1914) about half as much again as the big miscellaneous group." In the case of India, on the other hand, there is plenty of foreign capital and enterprise invested in this country but very little of foreign investments of our own. Further differences in environment, opportunities for investment, nature and amount of risk, the conditions of competition and similar conjunctural elements will necessarily affect the rate of profits. But as indicative of the tendency of the rate of profits, such a comparison is not inaccurate. In very recent years the flow of British capital and enterprise to India may not have been very free, and differences of opinion are possible on whether such ought to be the case. It cannot, however, be denied that for purposes of investment and enterprise the United Kingdom and India have not been exclusive and water-tight.

The trend of British profits can best be summarised in the words of the editor of the *Financial Times*[42] "From 1908 to 1930 profits were rising steadily; the Great War probably interrupted a cyclical down

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41. *J. R. St. S.* 1932, P 666

42. *The Economist* 17th Dec. 1938. p. 599 The adjoining Table XIII generally bears out these conclusions, though not in every detail.

swing and raised earnings to a point far above anything previously achieved; the collapse of trade activity and prices in 1921 brought down earnings, in the course of a single year, to the lowest level since the early days of the war; the pace of the ensuing recovery was perceptibly checked when great Britain went back to the gold standard in 1925; the Depression of 1930-32 cancelled all the gains of 1920's and it was only in 1937 that the profits at long last exceeded the level attained during the post war boom."

As already pointed out about 60% of the net profits is appropriated in the United Kingdom for equity dividends. We have also noted already that the rate of dividends follows closely the rate of return on invested capital and that it is therefore a dependable guide of British profit trends. The following table refers to the average of equity dividends of twenty groups of industries taken as a whole :—

TABLE XII

Ordinary dividends declared (rate%)

(United Kingdom)

1918	9·9	1930	10·3
1919	11·0	1931	8·4
1920	11·9	1932	5·7
1921	11·8	1933	5·6
1922	8·6	1934	6·1
1923	9·0	1935	7·1
1924	9·5	1936	7·9
1925	9·9	1937	9·0
1926	11·1	Mean	9·2
1927	11·0	Standard deviation	1·88
1928	10·5	Coefficient of variation	20·5
1929	10·3		

This statement points out the lowness of the rate which does not in any year reach even 12 per cent., the range of variation being 5·6 in 1933 to 11·9 in

1919. A further analysis according to different groups of industries yields the results as shown in Table XIII

The rate varies considerably between the various types. The average rate for two decades is the lowest in canals(2·7%) and highest in oils (17·2%) but the majority have declared less than 10% for the whole period. Very low dividends are found in the public utility enterprises such as gas, tramways and canals, and the highest rates in foreign investments like oil and tea. The variation in earning ability is more pronounced in particular years. Thus canals declared in 1919, 2·9% and in 1929, 1·2%, whereas oil declared 27·9% and 24% in the same years respectively.

It is also evident from the foregoing table that British industries can be divided into two types: (1) Industries with a steady rate, *e.g*, breweries, canals, trusts, electric power, light and telephones, etc., and (2) those with varying rates, *e.g.* textiles, oil, tea, etc. The range of variation in the former type has been, for instance, in canals 1.9% to 4.3% and in breweries 9·2% to 17·6%. Even these figures do not indicate the really stable rate of return. Thus, in breweries, only in three out of twenty years has the rate fallen below 12% and only in one been more than 17%, so that the true range of variation has been 12% and 16%. Among these steady industries, two classes are discernible: one with a steady but low return, *e.g.*, canals, gas and tramways, and the other with a steady but high return, *e.g.*, shops and stores, breweries and miscellaneous. High industries have thus consistently maintained high profits while the low ones have continued to yield low rates.

The second type consists of enterprises with a wide range of variation of earning power. To this class belong industries such as tea, rubber, textiles and shipping. In tea, for example, the rate was 35·1% in 1925 but only 2·9% in 1933. In six out of twenty years, the dividends exceeded 20% and in six other years have been less than 10%.

TABLE XIII

Ordinary dividends (rate%)

(United Kingdom 1918-37)

Types of Enterprises	Year ended June								
	1918	1919	1920	1921	1922	1923	1924	1925	1926
Breweries ...	9·2	10·4	12·0	11·8	12·8	13·6	14·8	14·5	16·2
Canals, etc. ...	2·7	2·9	2·5	3·8	1·9	3·4	3·6	3·9	4·0
Electric Light and Power ...	5·4	5·5	5·9	6·6	5·7	7·2	8·2	6·8	6·8
Gas	4·7	3·3	4·9	3·6	4·7	5·4	5·5	5·5	5·5
Hotels, etc. ...	6·6	8·1	10·8	10·1	8·8	6·7	9·2	9·9	12·3
Iron, Coal and Steel	13·4	12·9	13·4	10·5	7·1	4·9	5·0	4·1	3·3
Land, Mortgage, etc.	8·8	9·4	10·6	9·2	8·2	6·9	6·9	8·2	8·7
Motor and Cycle ...	11·8	17·4	11·7	8·6	2·8	2·2	2·8	4·1	5·6
Nitrate ...	17·9	12·3	12·4	15·8	12·5	10·2	14·3	12·0	10·5
Oil	12·1	27·9	26·3	28·9	24·0	22·2	18·2	18·3	18·7
Rubber, etc. ...	15·9	10·6	13·9	7·8	2·1	3·6	6·0	6·9	19·9
Shipping ...	12·5	13·1	11·0	9·9	9·1	8·3	6·0	6·1	5·7
Shops and Stores ...	15·5	12·2	22·4	15·0	8·3	11·1	10·2	11·7	13·6
Tea	14·2	13·6	15,3	5·5	9·3	19·2	32·6	35·1	33·1
Telegraph ...	6·8	9·2	11·1	9·5	8·4	8·9	13·4	8·6	8·7
Textiles ...	16·5	19·0	23·1	13·6	10·2	13·3	11·1	14·1	14·4
Tramways ...	3·1	3·8	3·3	3·6	3·7	4·1	5·2	4·0	4·2
Trust Companies ...	5·4	5·7	5·9	7·4	6·1	6·1	7·2	8·1	9·1
Water Works ...	4·5	5·3	6·1	5·7	5·7	6·8	7·1	7·2	6·6
Miscellaneous ...	12·2	12 0	12·4	13·6	9·8	10·9	11·4	12·8	12·9
Average ...	9·9	11·0	11·9	11·8	8·6	9·0	9·5	9·9	11·1

TABLE XIII

Ordinary dividends (rate %)

(United Kingdom 1918-37)

1927	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	Average (1918-37)
16·1	15·9	17·6	16·4	16·6	14·8	12·0	12·0	13·6	13·9	15·0	14·0
3·9	4·1	3·7	4·3	2·4	1·0	0·7	1·1	1·2	1·2	1·7	2·7
6·8 5·4	6·5 5·2	8·7 5·8	7·4 6·3	7·2 6·3	7·1 5·8	6·9 5·7	6·9 5·8	7·6 5·8	7·2 5·6	8·3 5·6	6·8 5·3
10·2	11·4	10·9	10·9	10·3	8·3	7·7	6·9	7·3	7·2	8·1	9·1
3·3	3·1	3·2	3·9	3·0	2·1	1·5	1·6	2·8	4·5	6·5	5·5
8·4	8·9	8·8	7·4	4·6	3·2	2·9	2·7	3·6	5·5	5·5	7·2
4·9	4·8	6·4	11·8	8·4	2·6	3·7	4·1	7·7	9·8	13·0	7.0
3·2	1·9	2·0	3·2	...	...	...	...	...	...	...	10·0
19·5	15·8	14·1	19·6	12·7	7·1	8·3	7·8	10·8	13·5	18·2	17·2
23·8	11·2	6·2	5·8	1·2	0·1	0·1	0·8	3·3	3·6	4·7	7·11
4·9	5·6	5·7	5·8	4·5	0·7	1·0	1·2	0·9	1·5	1·9	5·7
13·2	14·1	14·4	13·8	13·5	11·9	12·7	12·1	14·1	14·1	16·5	13·1
31·8	28·4	22·2	14·3	10·6	6·2	2·9	7·9	6·8	5·7	7·7	16·1
7·1	7·9	10·1	9·3	8·7	2·2	0·8	1·5	3·9	2·8	2·6	7·1
11·8	12·5	11·9	9·3	6·3	4·4	4·6	5·2	5·5	5·2	5·2	10·9
4·4	4·6	4·4	5·0	7·4	5·5	4·2	6·1	7·5	7·1	7·6	4·9
10·0	10·2	8·4	9·2	7·6	5·2	4·7	3·9	3·9	4·4	4·9	6·7
7·1	7·0	7·0	7·3	6·9	5·9	5·5	6·5	5·8	5·6	5·9	6·1
12 6	13·8	13·0	12·6	10·5	8·2	8·2	8·3	9·9	10·7	11·8	11·8
11·0	10·5	10·3	10·3	8·4	5·7	5·6	6·1	7·1	7·9	0·9	

Yet another feature of British profit trends is that different industries have been prosperous in different years. Thus the best years for oil, for instance, were 1919-1922, while for tea 1924-1929 were good years. The existence of considerable difference in earning ability among industries is further indicated by contrasting the highest and lowest yielders.

The average rate hides the extra-prosperity of individual concerns but sufficiently indicates how there is a taxable margin in some industries as a whole and more of this margin when individual firms are considered. "The tendency towards equalization of profit rates", writes an American authority [43], " is not sufficiently strong to prevent differences exceeding 100 per cent between the average profit rates earned by considerable groups of corporations from appearing and maintaining themselves over a full decade."

Trends in U.S.A.

The course of profits in the U.S.A. in the decade 1919-1928 makes an interesting study. Data regarding dividends declared are not easily available but the return may be worked out as a percentage income to capitalisation or as a rate of profit to total capital, *i.e.*, the share holders equity in the enterprise and all funded debt. As is evident from Table XIV, the rate of profits does not materially differ from whichever point of view we look at it.

After an exhaustive study Ralph Epstein comes to the following conclusion.[44] "For the ten year period, 1919-28, as a whole, the aggregate net earnings of these 3,144 large corporations amounted to 10·5 per cent upon their combined investment before taxes and to 9.2 per cent after taxes. In other words, an owner of the capital stocks of *all* these corporations would over this ten year period

43. *Industrial Profits in the United States* p. 587 ; see also Profits and Prices in prosperity and depression (*Q. J. E.* 1936-37).

44. *Ibid* p. 40

TABLE XIV

Profits in U.S.A. (1919–28.)[45]

	1919	1920	1921	1922	1923	1924		1925		1926		1927		1928		1919-28	1924-28
	C	C	C	C	C	C	D	C	D	C	D	C	D	C	D	C	D
Mining	4·5	6·0	0·9	2·9	5·1	3·8	3·9	5·4	5·3	6·4	6·2	5·1	5·1	7·9	7·5	4·9	5·4
Finance	15·0	12·6	7·8	12·2	9·8	10·2	9·9	10·8	10·3	10·4	10·1	10·2	10·0	10·4	9·9	10·7	10·4
All trade	24·2	11·4	6·6	14·9	15·4	13·4	13·0	14·0	13·4	13·6	13·1	13·1	12·6	12·3	11·7	13·6	13·0
All Manufacturing † ...	16·8	13·7	10·9	13·5	13·6	11·1	10·8	11·4	11·1	11·7	11·4	11·6	11·3	11·5	11·3	12·5	12·0
‡	18·3	12·3	2·9	10·2	11·2	10·0	9·5	12·1	11·4	12·4	11·7	9·5	9·0	11·0	10·4	10·8	10·2
Average	15·8	11·9	5·8	10·7	11·0	9·7	9·2	10·7	10·3	10·9	10·5	9·6	9·7	10·6	10·2	10·5	10·2
United Kingdom																	
Rates of earning on all capital ...	14·6	13·2	6·8	9·0	9·9	10·6		11·3		10·8		10·8		10·7		10·7	10·8
Rate of dividend	11·0	11·9	11·8	8·6	9·0	9·5		9·9		11·1		11·0		11·5		10·5	10·9

C = Percentage Income to Capitalisation. D = Percentage Profit to Total Capital.

† Small corporations. ‡ Large corporations.

45. Data from Epstein, *op. cit.*

have averaged approximately a 9% return upon his equity, year in and year out, although in one year his return might have been four or five times as great as in another, the range being 12·8% after taxes in 1919 to 2·4% in 1921." If large firms only are considered the range of variation is wider–either in any given year or over a period, varying in 1928, for example, from 1·3 to 27·3% and in 1921, from a loss of 12·6 to a net profit of 29·2%[46]

As between different groups of American enterprises, however, the earning rates over the whole decade or in any year vary widely in the different industries and trades. Thus profits of mining have been continuously low whereas trade as a whole has been prosperous. Manfacturing, on the other hand, has had a steady and moderate rate of earnings throughout the period.

If we analyse the major groups into minor or sub-groups their widely differing earning capacity is clearly indicated whether we consider the large or the small corporation type. Thus, retail has been 40 per cent. more profitable than wholesale trade in the whole period, and especially so between 1921 and 1928. The large manufacturing enterprises in the main do not earn profits at higher rates than the smaller ones. The data also point out that beyond a certain point mere size does not mean, in terms of earning power, increased effectiveness in production. Profits in terms of invested capital are higher in a good number of smaller concerns than in the largest corporations.

In the manufacturing industry also, we find wide differences in earning capacity ranging from 5·9 in rubber to 18·4 in special manufacturing industries, if the average for the decade is considered. But in particular years variations are more pronounced not only between the different industries but even in the same industry. Thus, in the leather industry the range of

46. *Q. J. E.* 1936—37 p. 686.

variation has been between 2·4% in 1921 and 34·1% in 1919 although after 1921 there has been a steady and reasonable rate of return, *viz.*, about 12%. In Epstein's words [47]: "Taking the decade 1919-28 as a whole and aggregating the annual earnings for all ten years in each of these 106 industries we find that their earning rates for the entire period range from 1·9% to 31·6%. Twenty industries show earnings from 1·9 to 9·9%; 57 earned 10 to 14·9%; 22 earned from 15·5 to 19·9%. The remaining seven industries earned from 20 to 31·6%. The *most common return* is thus between 10 to 14·9%." "Half of the 73 industries," concludes Epstein,[48] "show earnings for the ten years, of over 13·6 percent. upon investment; the highest quarter earn over 15·8%, while the lowest quarter earn under 10·6 per cent." Not only do discrepancies exist among the earning rates of different industries but the high industries of any given year are also high industries in succeeding years. "When the industries that show the highest rates of profits in any given year are followed through successive years and their earning rates checked they show no substantial decline in earning power."[49]

In some enterprises long-time increases or declines in relative earning power may be observed.[50] But secular influences of this sort do not suffice to bring about any approximate uniformity of long-run return; at least competition brings no such result about over the ten-year period studies. While some of the high industries are those characterised by the possession of trade marks, etc., few are industries commonly regarded as subject to monopoly control. Nor are they really monopolised in any usual sense of the term. Numerous independently owned enterprises operate and compete in each of the industries in question.

Thus, we find that in some types of enterprises the average rate of profits is not only high but

47 *Ibid* p. 42 48 *Ibid* p. 43 49 *Ibid* 50 *Ibid* p. 44

persistent. The average, however, does not show the true state of affairs. "In every industry", remarks Ralph Epstein,[51] "wide variations exist between the average return on investment and the rates received by the individual corporations whose incomes and capitals contribute to that average figure." In other words, the average includes both the relatively profitable and unprofitable enterprises. The existence of profits higher than the average indicates the margin for excess profits taxation.

Epstein's comment on the differences in earnings is very significant. He charactarises[52] as loose and misconceived the statement that there is a tendency to equality between the different industries, differences in risks considered. "An excess of return in any one industry over the average rate in a good year, in so far as it constitutes a risk differential, would be received in order to offset a deficiency of return in a bad year; and if the principle which holds that differences in profits serve to equalise differences in risks were true the differential surpluses of the good years would, over a period, exactly equal the differential deficits of the poor years . . . . The Classical doctrine of compensation for risk can properly be applied in the explanation of such differences in earning rates as exist in any one year, but not in the explanation of discrepencies that prevail over a long period."

The differences in the profits of the individual concerns may be illustrated by the case of steel and equipment in the U.S.A. as given in the following table.[53] It may be noted how, during the pre-1914 war period while Sloss Sheffield was making 3%, Westinghouse Airbrakes were earning 17·3% though the average for the whole steel industry was 6.%. A greater

51. *Ibid.*

52. *Ibid* pp. 87-88. See also the table in B. M. Manly: Have profits kept pace with the cost of living (*Annals* 1920 p. 163.)

53. B. D. Mudgett: Course of Profits during the War. *Annals* 1920. pp. 153—156.

difference in profits of the two concerns is noticeable in the war period. The same difference in the earning ability of the individual enterprises is evident in other industries also.

TABLE XV

Profits of some steel concerns in U.S.A.

NAME OF CONCERN	Pre-war period	Total war period	U.S. neutral period	U.S. belligerent period
1. U.S. Steel	6·8	12·2	11·3	13·5
2. Sloss Sheffield ...	3·0	6·5	4·8	9·1
3. Lackouvana Steel ...	4·3	14·9	10·2	22·0
4. Crucible Steel ...	5·6	15·7	14·9	18·1
5. Bethelhem Steel ...	7·1	32.5	41·7	18·7
6. Republic Iron and Steel	4·3	12·8	10·7	16·0
7. Railway Steel and Spring	4·6	8·6	5·8	12·9
8. Pressed Steel Car ...	4·4	6·0	4·9	8·6
9. American Locomotive ...	5·7	8·8	8·9	8·5
10. N.Y. Air Brake ...	5·4	23·4	31·3	11·5
11. Westinghouse Air Brake	17·3	24·4	21·2	34·1
Average for Steel and Equipment ...	6·2	15·1	45·1	15·7

The preceding analysis of American conditions indicates, that the average rate of earnings for 1919–28 for industry as a whole has been about 10 per cent though the return has varied in different years; secondly, this average hides the wide differences in earning rates of the different types of industries among which the earnings of some have exceeded 20% when the whole decade is considered; thirdly, this high rate of profits has been persistent so that some industries consistently earn high rates, indicating that there is no equality of return between the industries; fourthy, these differences are not explainable by the differing element of risk; and finally, these

high average rates of earnings hide the variations among the individual concerns, which really are the excess tax bearing units. Analysing the effect of the excess profits tax in U.S.A. during the First . orld War, Epstein concluded [54] that the tax was not so high as to penalize earning power to such an extent as could wipe out relative differences, for, the industry remaining most profitable after taxation earned 43·13 per cent. net, while the industry that was least profitable after the tax earned only 8·11 per cent.

Comparison between India, U.S.A. and U.K.—

We might now compare the trend of profits in India with the trends in the United Kingdom and the U.S.A., especially with the former, since the more easily comparable data, *viz.*, dividends, are available for both the United Kingdom and India. Further, as already pointed out, there is more of mobility of capital and enterprise between the two countries than between India and the U.S.A. The following figures are significant.

Average earnings (all types of enterprises)

1919—28

India	17·1 per cent
United Kingdom	10·5 ,,
U.S.A.	10·6 ,,

(*Note.*—In the case of India and the United Kingdom, the rate refers to ordinary dividends and with regard to U.S.A. to rate of profits to capitalisation.)

The similarity in the rate between the United Kingdom and the U.S.A. may be noticed. Equally obvious is the difference between India and the other two countries ; our rate of dividend being 50% higher even when the average for the decade is considered. This difference is more marked when the full twenty year period is taken into consideration :

Average dividends

(All types of enterprises)

1918—37

India	14·1 per cent
U,K, ...	9·2 ,,

This conclusion that profits in India have been

54. Industrial Profits in 1917 (*Q.J.E.* 1925 P. 264.)

higher than in the U.K. is confirmed by a study of the rates in different industries for the two decades (1918-37).

TABLE XVI

TYPE	U.K.	INDIA	TYPE
	%	%	
Oil	17·2	44·7	Jute
Tea	16·1	23·3	Cement, lime, etc.
Breweries	14·0	20·6	Paper
Shops and stores ...	13·1	20·6	Cotton
Miscellaneous ...	11·8	19·3	Insurance
Textiles	10·9	17·3	Flour mills
Nitrate	10·0	15·0	Tea
Hotels, etc.	9·1	12·8	Sugar
Land mortgage, etc. ...	7·2	12·7	Banks
Rubber, etc.	7·4	10·8	Coal
Telegraph	7·1	10·8	Pressing companies
Motor and cycle ...	7·0	10·5	Engineering and metals
Electric light and power...	6·8	9·0	South India rubber
Trust companies ...	6·7	8·6	Miscellaneous
Water works	6·1	8·3	Tramways, etc.
Shipping	6·7	7·8	Real property
Iron, coal and steel ...	5·5	7·5	Saw mills and timber
Gas	5·3	7·4	Chemical industries
Tramways	4·9	6·4	Oil
Canals	2·7	6·1	Electric power and light
		5·5	Light railways

No doubt the enterprises are not similar in the two countries, but since they represent most of the important types of investments in both places, the profits are comparable. It may be noted that only two industries in the United Kingdom have declared more than 15% for the whole period and even these

fall far short of 20%. In India 6 industries have had an average rate exceeding 15% and 3 of these exceed 20% while one passes the 40% limit for the whole period. At the other end, in the United Kingdom 65% of the groups have earned less than 10% while in our country this class forms only about a third; and the lowest rate earned in the two countries has been 2·7 and 5·4 respectively.

This difference in earning ability becomes clear when the highest and lowest yielding enterprises are compared. As samples may be taken the following five highest yielders and five lowest yielders in India, the U.K. and the U.S.A.

TABLE XVII

Highest rates of dividend%

(Average)

U.K.

HIGHEST			LOWEST		
INDUSTRY	1918-37	1919-28	INDUSTRY	1918-37	1919-28
Oil	17·2	21·9	Canals, etc. ...	2·7	3·4
Tea	16·1	22·3	Tramways ...	4·9	4·0
Breweries ...	14·0	14·6	Gass	5·3	4·9
Ships and Stores ...	13·1	13·3	Iron, Coal and Steel	5·5	6·7
Textiles ...	10·9	13·3	Shipping ...	5·7	7·8

India

HIGHEST			LOWEST		
INDUSTRY	1918-37	1919-28	INDUSTRY	1918-37	1919-28
Jute Mils ...	42·7	59·8	Light Railways ...	5·4	6·0
Cotton Mills ...	20·6	30·1	Electric Light, Power and Phone	6·4	6·4
Flour Mills ...	18·3	28·9	Oil Companies ...	7·0	6·2
Insurance ...	19·2	20·0	Chemical Industries	7·4	9·1
Cement, Lime, etc.	23·3	25·0	Real Property ...	8·0	11·6 For 1920-28 only

U.S.A.

HIGHEST		LOWEST	
INDUSTRY	1919-28	INDUSTRY	1919-28
Toilet Preparations ...	31·6	Meat Packings ...	1·6
Newspapers	25·6	Beverages	3·8
Scientific Instruments ...	25·5	Castings and Forgings ...	5·8
Mis. Printing and Publications ...	22·9	Rubber Products ...	5·9
Proprietary Preparations	20·8	Mis. Leather Products ...	6·8

Whether we take the decade 1919-28 or the longer period it is plain that the return in India is, on the whole, very much higher than elsewhere; in fact, Indian dividends are about 50% higher than in the U.K. Even our lowest rates are higher than their counterpart in Britain. As between America and Britain, we may notice the wide variations in earning ability between extremes in the United States. In India, the variations are also great, though our highest and lowest are higher than elsewhere.

The wide difference in earning ability becomes more prominent when we analyse the fortunes of particular industries in particular years. The highest

rate of dividend declared *in any year by any industry* between 1918 and 1937 in the United Kingdom is 35% in the tea industry and this rate is found only in one year. The highest rate declared in our country has been *141* in jute in 1918 and in 3 years the rate has exceeded 100% apart from particular firms which have declared more than 300% (*vide* Table IX). The average rate of 30% for the whole industry has been attained in a good number of years by a large number of industries. This inference is borne out by the following analysis.

TABLE XVIII

Ordinary dividends (Average rates)
(India)

Type of Concern	No, of years for which figures are available (1918-39)	No. of years in which rate of dividend has exceeded	
		15%	25%
Banks	20	5	...
Jute Milis	22	15	12
Coal Companies	22	7	...
Tea Companies	21	7	3
Pressing Companies	20	1	...
Oil Companies	20	1	...
Iusurance Companies	22	18	4
Real Property and Zamindari ...	20	3	2
Paper Mills	22	12	5
Cement, Lime, Pottery, etc. ...	22	...	...
Chemical Industries	22	...	...
Electric Light, Power, Telephone ...	22	...	...
Engineering and Metal-works ...	22	6	2
Flour Mills	21	12	4
Saw Mills and Timber	19	2	2
Sugar Refineries	22	7	...
Tramways, Steamer transit and storage	22	...	...
Miscellaneous	22	3	...
South India Rubber	17	3	2
Cotton Mills	20	6	5
Light Rail ways	22	...	...
TOTAL ...	442	108	41

TABLE XIX

Oridnary dividends (Average Rate)

(United Kingdom)

Type of Concern	No. of years for which figures are available (1918-37)	No. of years in which rate of dividend has exceeded	
		15%	25%
Breweries	20	6	...
Canals, etc.	20	...	...
Electric Light aud Power ...	20	...	...
Gas	20	...	...
Hotels, etc.	20	...	...
Iron, Coal and Steel	20	...	...
Land Mortgage, etc.	20	...	...
Motor aud Cycle	20	1	...
Nitrate	13	2	...
Oil...	20	12	3
Rubber, etc.	20	3	...
Shipping	20	...	...
Shops and Stores	20	3	...
Tea	20	8	5
Telegraph	20	...	...
Textiles	20	3	...
Tramways	20	...	...
Trust Companies	20	...	...
Water Works	20	...	...
Miscellaneous	20	...	...
Total ...	393	38	8

It may be noted how there are only 8 instances (3 in oil and 5 in tea) when the rate has exceeded 25% and even these relate to foreign investments. On the other hand in India, we know as many as 41 instances. In some industries like jute, 12 out of 22 years have witnessed dividends exceeding 25%. Even the lower rate of 15% has been attained in the United Kingdom in only 9 per cent. of the cases and more than half of these are accounted for by oil and tea. In India, nearly a quarter of the cases have earned more than 15%.

The low profit rate in Germany for 1926-38 is given below and brings out this conclusion more emphatically.[54]

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54. German Corporate profits: 1926—38 (*Q.J.E.* 1940 pp. 390—91).

TABLE XX

Profit Ratios of German Corporations According to Industrial Classes and Composite Groups

Type of Industry	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938
1. Heavy Industry	2·1	4·89	5·02	4·06	1·63	-12·7	6·94	1·59	4·92	6·01	7·53	7·41	6·44
2. Light Industries	4·25	7·81	5·37	4·4	2·1	-7·7	4·0	2·3	4·6	4·9	6·1	6·7	6·0
3. Fine mechanics and optics ...	....	3·9	3·7	0·8	-5·9	-20·7	6·3	-0·2	3·4	3·9	7·0	....	....
4. Luxuries	3·9	6·2	4·9	3·1	-2·0	-17·6	15·9	-7·6	7·5	-0·6	2·0	....	....
5. Building trades and materials ...	3·4	9·0	8·5	3·5	4·5	-12·6	11·8	1·0	3·7	3·2	6·7	7·6	9·0
6. Chemicals	5·2	8·5	9·4	7·7	6·0	1·3	2·0	4·1	5·2	5·3	5·9	6·2	6·1
7. Transport (railways or buses) ...	4·2	4·8	3·9	4·5	2·2	-18·4	14·2	-0·1	-0·3	0·06	0·5	1·7	2·4
8. Water, gas and electricity ...	6·9	6·6	6·3	6·2	5·5	4·5	4·1	0·4	4·5	4·8	5·4	5·4	4·9
9. Finance	10·4	8·6	8·8	8·5	4·5	-32·2	5·4	2·0	3·9	4·2	4·5	6·2	5·7
10. All	5·1	6·8	6·1	4·5	2·7	-10·5	3·6	0·7	3·5	4·2	5·3	6·1	5·6

It is thus clear that profits as represented by dividends in India are much higher than those in the United Kingdom or even the U.S.A., whether we look at them as an average for all undertakings or for the same type of undertaking for the whole period under consideration or whether we take particular industries and particular firms. It is possible to argue that the lowness and steadiness of the ordinary dividend are deceptive and may be due to stock-watering, equalisation of dividends or some other method of hiding profits. It is indeed difficult to imagine, however, that this explanation is particularly applicable to the profits in the United Kingdom and not to those in India.

FINAL CONCLUSIONS

The preceding factual analysis of the profits emphasises certain tendencies. Both in the U.K. and in the U.S-A., there are industries which earn high profits, although in the U.S.A., the earnings are higher. There is greater steadiness and stability in profits in the former than in the latter. The industries which earn large profits have a tendency to earn high rates throughout a long period so that the profits are persistent and not accidental. Thus, there is in the U.K. and the U.S.A. scope for the levy of an excess profits tax in *normal* times.

With regard to India, it is clear that the rate of profits is higher than in the United Kingdom, where the differences between the rates of interest and the rates of profits are not very great, as contrasted with our country where there is a wide gulf between the two. Secondly, this high rate of profits has been persistent, though latterly it has shown a tendency to decline. Phenomenal profits are, therefore, not due to abnormal conditions such as the war and its immediate after-effects, although such abnormalities have increased the rates still further. Thirdly, this high rate is especially noticeable in a few industries.

Further, while the average profits are high, those of a considerable number of firms are phenomenal. Finally, this fact is especially important for purposes of taxation since the excess profits tax affects not all firms, but only those with abnormal profits.

CHAPTER IV

The Taxable Excess

I. SCOPE OF THE TAX

The scope of the tax may be viewed from four standpoints, *viz.*, (i) assessable occupations; (ii) structural basis; (iii) size factor; and (iv) place of operation.

ASSESSABLE OCCUPATIONS

Since the tax is a levy on profits, it applies wherever profits arise. Profits are a special kind of income associated only with business and consequently the tax can be levied on businesses only. What exactly constitutes a business is a matter of dispute and must be decided on the merits of each case. "The word 'Business'", observed Justice Finlay,[1] "is only a convenient way of expressing a trade, manufacture, adventure or concern in the nature of trade." A fundamental feature of business is the continuous exercise of an activity,[2] and this would exclude isolated transactions and their profits. Equally important are the characteristics of the employment of capital and the earning of profits by a procees of production.[3] This feature helps us to distinguish taxable business from non-taxable occupations.

Farming

Is farming a business liable to the Profits Tax? In many countries this occupation in general has not been taxed largely on administrative grounds.[4] But doubts have been raised as to the justice of the exemption.[5] On *principle*,

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1. St. Aubyn's Estates Ltd., vs. Strick (1932, 17 Tax cases 412)
2. Shaw Wallace & Co.'s case (1931, 59 & A. 206).
3. *Ibid.*
4. I France, for instance, the exemption was granted as a privilege to the peasant (*The War Finance of France* by Jeze and Touchy.) Under the 1940 E.P.T. Law of Great Britain agriculture was *not* exempted.
5. Haig. *Report on The Taxation of Excess Profits in Great Britain*, p. 29

there is no ground for exempting agricultural net incomes, for agriculture involves the investment in land, of capital and other requisites of production, and the net income is similar to that from any trade or industry. It may be argued that agriculture already pays the land and income-taxes and that a further tax would be unfair, but this objection appears unsound since the three taxes are levied entirely on different bases and since other businesses also pay more than one tax. On *administrative grounds*, however, husbandry may not be taxed. Agriculture is, even to-day, carried on on a comparatively small scale and especially so in India, and, therefore, it is both inconvenient and expensive to apply the tax to the hundreds and thousands of farmers. As an official of the Inland Revenue in the United Kingdom put it,[6] the duty on the farmers would not have been worth the labour necessary to gather it. Moreover, agricultural profits are, perhaps, normally nowhere excessive enough. There are, however, some types of farming, such as dairying, poultry-keeping and cattle-rearing and also plantations and mechanised large farms which can claim no exemption. In all these cases, the test to be applied for exemption purposes is not the occupational basis but the size factor, *i.e.*, on grounds of the smallness of the undertaking.

Professions

Next comes the case of professions and allied occupations. It has been the general practice to exclude professions from taxation but there have been exceptions. Thus, the Russian War Profits Tax of May 1916 extended to the personnel of joint-stock companiesand professions, who were taxed at 20 per cent. on income in excess of 500 roubles over the 1913-1914 level.[7] In U.S.A,, they were taxed under the 1917 Act at 8 per cent. of the

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6. *Ibid* footnote.
7. *Russian Public Finance during the War.* pp. 165 and 179-180 (Carnegie Series.)

net income; and in some cases a lumpsum varying in different industries was exempted, the excess being liable to taxation; but in 1918 the tax was applied only to corporations. Such exemption was criticised in U.S.A. as well as elsewhere on the ground that certain professional incomes also swelled during the war. Even in 1939, Sir Henry Morris Jones, among others, expressed a similar attitude in the British Parliament.[8] Some academic writers[9] also have felt that the principle of the tax may be extended to all non-incentive income, whether from capital or other sources. 'At bottom', contended T. S. Adams,[10] the American expert on excess profits taxation, "I can see no reason why a lawyer or engineer whose earnings are supernormal should be exempt from the excess profits tax."

Two questions naturally arise in this connection: What are professions? Should they be taxed? It is difficult to demarcate clearly a profession from a business, because, in Lord Justice Scrutton's words,[11] "people carry on such infinite varieties of trades and businesses that it is a question of degree in every case whether the form of business that a particular person carries on is or is not a professson." Whether a particular occupation is a profession or not is a question of fact and must be left, as in the United Kingdom and other countries, to the Board of Referees administering the tax or to a court of law. But certain characteristic features of a profession may be pointed out to indicate why professions should be exempted. Generally professions depend largely on personal qualifications, and brain and skill are more important than capital.[12] These qualifications may have been built up by expenditure on acquiring them but only by straining argument can the amount so

8. House of Commons Debates, 4th Oct. 1939: Discussion on Clause 12.
9. *P.S.Q.* Vol. 55, No. 4, pp. 537-38.
10. *Q. J. E.* 1921, p. 390.
11. Currie's case (12 Tax Cases 245).
12. Maxse's case (12 tax Cases 41).

spent be regarded as invested capital. It is also impossible to know such expenditure definitely. After all, mere expenditure is not enough to enable a person to carry on a profession. The income, therefore, is the return for skill rather than for capital invested. The tax under consideration is a levy on profits which are associated with business and capital, and professional incomes are not profits. If the tax is applied to all individuals, it would cease to be a profits tax and become a general income tax.

Apart from this objection on grounds of principle, there is an administrative difficulty. As the British Chancellor of the Exchequer said, while introducing the tax in 1939,[13] inclusion of professions would mean an enormous extension of the examination of individual cases and the amounts which would be got as revenue would be unimportant in comparison. It is, therefore, wise to follow the British procedure[14] of exempting from the excess profits tax, professions, the profits of which are dependent mainly on the personal qualification of the person by whom the profession is carried on and in which no capital expenditure is required or only capital expenditure of a comparatively small amount. Such exclusion does not, however, mean that excessive incomes should escape taxation, for they must be approached by a different tax or a different method such as steeper progression and legislative restriction on remuneration.

Another class of incomes difficult of classification arises from investment in property of various types,

Rentier class

e.g., securities, real property, etc. These may be called the *rentier class*. During the First World War, there were two taxes in Germany –a property increment tax applying to individuals and an excess business income tax relating to companies. In other countries also this class of rentiers was assessable. But it seems generally unfair to include these

13. House of Commons Debates on Finance (No 2) Bill, 4th Oct. 1939.

14. Finance (No. 2) Act, 1915, Sec. 39.

incomes for excess profits taxation, for they are not business profits but unearned incomes arising outside the regular course of business. Moreover, ordinarily these incomes show no excessive fluctuation. There may occasionally be abnormal increases in the capital value or even in the income value of investments, e.g., site values, house rent, royalties, etc., but such increases are not profits and must be mulcted by other levies such as increment value duties and unearned income tax For, the theory of the profits tax is that it is levied on the profits of business and not on income from investments, except where the essence of the business is investment e. g, holding companies and their subsidiaries, insurance firms, investment corporations, etc.

Interesting problems of multiple taxation and evasion would then arise. Suppose a concern, like the Imperial Chemical Industries, has established hundred per cent. holdings in some of its subsidiaries. Should the excess profits be considered in terms of the subsidiaries and their capital, or should the principle of aggregation of profits accruing to the parent company be followed? Obviously, the tax cannot be levied on both occasions. If the tax is not progressive, it would not be very material as to when it is collected provided it is not collected over again. But if it is graduated, the aggregation of profits in the hands of the holding company would be liable to a steeper rate. Further, a minimum sum of profits may be exempted on purely administrative grounds according to the criterion of the size factor.[15] And a holding company may so disperse its investments that the profits it receives from any one of the subsidiaries is of the exempted amount, and thus possibly avoid the tax altogether. Therefore, it is preferable to tax the holding company's receipts. But where the subsidiaries are taxed on administrative grounds, the profits in

15. In the 1940 Indian tax, the exemption was Rs. 36,000 whereas in the United Kingdom it was £3000. *Infra*, p. 136.

the hands of the parent concern must be charged at the higher rate and the balance due collected.

The foregoing principles should apply even in the case of holdings of less than 100 per cent. For, the definition of a subsidiary as given by the Cohen Committee on Company Law Amendment may be followed. The Committee do not regard the holding of the majority of the capital as the single or even the best criterion. They prefer to take as the best, with certain exceptions, the power to appoint a majority of directors, either directly or indirectly, and in any case, a company in which more than fifty per cent of the equity capital is owned by the parent and its subsidiaries, may be regarded as a subsidiary. It is, however, inequitable to follow the British practice under the 1940 Act according to which shareholdings in subsidiaries of less than 90 per cent. are presumably to be treated as invesments, and the income from such holdings, having already attracted the excess profits tax before the subsidiaries pay their dividends, will again be liable for the excess profits tax, when the parent company takes these payments into its income. Such double taxation can be avoided by taxing only the subsidiaries and collecting the balance at a higher rate, if any, when the profits are in the hands of the parent company.

No ready-made final solution, however, is possible and the problems must be tackled as they arise.

Other financial institutions, such as banks and insurance companies, also cannot escape taxation since they are businesses earning profits. They, however, give rise to special problems pertaining to fair return, invested capital and profits, which are matters of detail to be considered by the tax-administering authorities.

Thus, all businesses which earn profits are liable to the excess profits tax and whether a particular assessee or income-earning body comes under this category is a question of fact to be determined on the

THE STRUCTURAL BASIS

The organisation of a concern is another important aspect of the scope of the tax. Structurally, a business may be a proprietorship, an incorporated or unincorporated concern or a co-operative one. There are some, who believe that a distinction should be made between incorporated and un-incorporated enterprises. "Both in principle and in practice, however," writes Carl Shoup,[16] "there are grounds for distinction though they may or may not be strong enough to justify exemption ..... In principle it is the absence of limited liability that makes the difference." It is contended that the element of risk is greater in unlimited concerns since all assets, and not merely the invested capital, are at stake and that, therefore, a larger amount of capital than is apparent must be allowed for in the case; further, in practice, great difficulty is felt in ascertaining the amount of assets actively used in the business since proprietorial businesses are not as keen and clear about accounting and business capital.

Un-incorporated businesses

But, these contentions should not affect the liability of the business for excess profits taxation. At best, they may mean special methods of capital and profits calculation, i.e., questions of accounting rather than of principle. Further, it is very far-fetched to say that, from the point of view of the business and the profits it makes, the capital at stake is very much larger than the invested capital. What really matters is the amount of capital that is responsible for the profits of the concern and not who owns the capital and how. The financial consequences of exempting non-corporate businesses can be guaged by the fact that, in U.S.A., between 1924 and 42, the ratio of individual and partnership profits to corporation incomes varied from 86·5% in 1924 to 35·8% in 1936[17] i. e.

16. *P.S.Q.*, 1941, p. 227.

17. Lutz: *A Tax-Program for a Solvent America* P. 61, Table XIII.

between a third and five-sixths of the profits and assessable firms would escape taxation.

In practice also, discrimination is made on structural grounds. Thus during the First World War, when Canada adopted the Capital Standard, the normal rate was 7 per cent. for corporations and 10 per cent. for non-corporate businesses. Differential treatment was also found in Great Britain and other countries. Under the British law of 1939 the standard profits allowed differed in the two cases—8 per cent. for companies and 10 per cent. for firms.[18] This practice was largely founded on the ground of personal equation, i.e., the remuneration for the owner's labour. In large concerns salaries are paid and computed as cost, but among sole propietors, partnerships and small concerns salary deduction is neither possible nor complete. There are many trades and industries in which the personal element is the chief factor. Even among large corporations, officers are to-day paid sometimes in shares of the net income so that the personal equation pervades all business. It cannot be provided for completely by salary deduction. The following figures prepared by the U.S.A. Treasury Department show that the excess profits tax bears more heavily on small corporations when the personal factor is not eliminated.[19]

TABLE XXI

Rate of Net Income to Invested Capital

Revenue Act of 1917

Corporations having invested capital of $	Less than 20% (Tax less than 12·25% of net income)	20 to 40% (Tax from 12·25 to 31% of net income)	40 to 60% (Tax from 3 1 to 40% of net income)	Over 60% (Tax over 40% of net income)	TOTAL
Less than ...	No. 54	383	296	329	1065
20,000 ...	% 5·1	35·9	28·1	30·9	100
Less than ...	No. 1671	1514	318	124	3629
100,000 ...	%46·1	41·7	8·8	3·4	100
Less than ...	No. 1576	640	- 143	65	2424
500,000 ...	% 65	26·4	5·9	2·7	100
Less than ...	No. 518	171	40	14	741
5,000,000...	%69·9	23·1	5·4	1·6	100
Over ...	No. 36	6	0	0	42
5,000,000...	%85·7	14·3	0	0	100

The difficulty led in the United Kingdom to the limited application of the duty and a higher statutory percentage for individuals, partnerships and personal service corporations while in U.S.A. there was total exemption. Although the personal element must be provided for, the American procedure of exempting certain concerns is indefensible, while the British procedure of providing for personal equation by a larger normal allowance is justifiable only on grounds of adminstrative convenience. Equity demands that remuneration must be allowed as a cost to be deducted from the taxable profits and this element does not necessarily depend upon the rate of profits a concern would make. It must, therefore, be determined independently of the profits earned. Perhaps, instead of a uniform rate of allowance for all types of concerns, rates differing in different varieties of businesses would be more equitable, and these may be determined by investigations into the different varieties or by the process of allowing appeals by businesses to the Board of Referees. This procedure would no doubt be equitable in theory but would perhaps be a little cumbersome and administratively troublesome. So

purely on grounds of administrative convenience, the British procedure of adding a small percentage to the normal rate of profits may be followed in the case of businesses where the personal factor is not adequately provided for.[20]

Similar is the question whether co-operative societies and ventures of local authorties should be taxed. Although special methods of calculating the duty were provided, societies in the United Kingdom were taxed on the ground that the tax was "a charge upon the profits of the enterprise as such, rather than upon the resources of the individual members." Their inclusion is perfectly justified, because they are private organisations though their object is prevention of exploitation of the members. They are not expected to make any profits at all and if they do, the profits are returned to the members. A society earning excess profits is really un-co-operative. Further, in essence, a co-operative organisation is a private concern intended for private benefit and can, therefore claim no exemption but perhaps some concessions, depending upon the broader policy of extending the cooperative movement.[21]

Cooperatives

On the other hand the venture of a public body such as a local authority is on a different footing. In Britain the Excess Profits Duty was applied to Local Government authorities though the net profits of all undertakings of the local authorities were taken into account rather than the profits of any one undertaking. The local authority is really an

Local bodies

20. *Infra.*

21. It may be pointed that in U.S.A. co-operatives have grown up and become big business under tax exemptions and other concessions. The farmers' societies, especially, have earned large profits. Thus the Farmer's Union Grain Terminal Association of St Paul, earned in 1944, 2 million dollars, but returned it to the farmers "untouched by the Federal Income tax and taxed only once as income to each individual member and so at a much lower rate than the corporation profits" (*The Economist* 23rd June 1945, p. 851).

instrument and limb of the state which collects and spends the excess profits tax revenue. The accruing profits are returned to the people and benefit society in the same way as the profits of any Central Government concern. It must, therefore, be the object of the state to *discriminate in favour* of public enterprises so as to encourage their growth. Thus, on grounds of principle, excess profits taxation of local authorities is unjustified.

SIZE FACTOR

An important consideration relating to the scope of any tax is its practicability which depends partly on the type and number of assessees. Thus, in the income tax the exempted level is partly due to practicability in that it is neither convenient nor economic to approach innumerable small units. That all enterprises earning excess profits should be taxed may be acceptable as a principle but it may not be worth while considering small businesses.

Small businesses might be exempted from the tax solely on account of the administrative difficulty of approaching them with regard to capital and profits calculation which would increase the cost of collection and on account of the improbability of any appreciable revenue. Small concerns are spread out in the country to a much larger degree than large ones. Further, the growth of prosperous small businesses may not be undesirable and perhaps even welcome, so that the application of the tax from the standpoint of controlling the growth of firms and industries also does not hold good.

Difficulty, however, arises in defining the size of the business exempted. Three alternatives are possible (1) the income aspect, i.e., profits, (2) the finance aspect, i.e., the size of the capital invested, (3) the physical aspect, i.e., the size of the firm, as indicated by the number of people employed, similar to the distinction between workshops and factories. The last of these, if adopted, would exempt concerns like stock

broking and trades which employ few people in proportion to their income and would discriminate against manufactures, mines, etc. Neither the profits earned nor the capital invested has any connection with the number of people employed, so that the physical size of the firms is of no importance in the excess profits tax. Similarly, the size of the invested capital; for it would discriminate in favour of businesses which have little capital, although their profits may be high.

Thus the main criterion ought to be the size of the net profits. According to this test, concerns getting the minimum exempted amount need not be bothered with for the tax. A good number of businesses in our country would come under this category and in fact, all cottage industries, petty trades and farming would automatically be excluded from the purview of the levy, thus simplifying the administrative factor. For instance, under the still-born British National Defence Contribution, profits of less than £ 2,000 were entirely exempt and the full charge was not to be applied until the profits reached £ 12,000. Under the excess profits tax of 1939, the exemption was generally £ 1,000 but a partnership was allowed £ 750 per working partner upto a maximum of £ 3,000.[22] While the general exemption is based upon the size factor, the special case of partnerships is the result of the personal equation factor, i.e., to provide for directors' or managers' remuneration and of the need for providing for the greater risks in a partnership.[23] As a *minimum standard principle*, this procedure is defective and cannot be recommended, for, the exemption must depend upon administrative convenience and cost and not upon the structure of the concern. What the size of the minimum profits should be is a matter of detail, depending on the environment, but I should suggest it

22. Section 13.

23. *Vide* Sir Jeremy Raisman's explanation while accepting an amendment to raise initial exemption in the Indian tax from of Rs 20,000 to Rs. 36,000 *Legislative Assembly Debates* 1940 Vol II No 9 p. 1539.

as Rs. 20,000 for a country like ours. In fact, Sir Jeremy Raisman had orginally put it down at Rs.20000. Under the Canadian law of 1940, the minimum taxable profits were 6,000 dollars.[24] Businesses earning less would be regarded as too small for purposes of even condsideration for excess profits taxation. Those getting larger profits would be liable to the tax provided the rate of profits in relation to capital is excessive, though they would also be entitled to the minimum.

PLACE OF OPERATION

Another consideration is whether the origin of profits or the location of the concern should be the basis of the levy. This is important especially in countries like India, China and the South American Republics where external capital and enterprise are considerable. Should a British concern incorporated in England but carrying on business, say, mining in India, be taxed on its mining profits? Should an Indian concern carrying on business in South Africa but owned in India be taxed? Both location of a concern and origin of profits must be grounds for taxation from the point of view of any particular country. This would, however, involve some amount of double taxation which evil may be remedied by bilateral relief agreements.

II. THE CRITERIA OF THE NORM

There are two methods of arriving at the normal profits and thus at the taxable excess-the Income Standard and the Capital Standard. Each method is known by other names as well. The Income Standard has been called the base period method, the British method, the accrued profits standard, the pre-war profits principle, while the other has been known as the general or statutory percentage standard, the American method, the invested capital method,

24. *Canadian Excess Profits Tax Act.* 1940 Section 7 and 7A.

the normal profits principle, etc. Each of these has subvarieties and was in operation during the First and Second World Wars, either by itself or more commonly as an alternative to the other. Thus, in the United Kingdom tax of 1915 and the Indian tax of 1919 the taxpayer could choose either norm and whichever was higher, while in the 1940 levy, the option was still there but restricted in scope.

THE INCOME STANDARD

Its features

There are fundamental differences between the two methods; in fact their approach to the problem of the norm is entirely from different directions. The essence of the Income Standard is the acceptance of the past income as normal. The profits actually accruing to the assessee in the pre-tax year or period—when, instead of one year, the average of a number of years is considered—are accepted as the standard level exempted. "A business concern," observes T. S. Adams, "which can truthfully be said to have established a given level or volume of profits may fairly claim that volume of profits as its *normal* return." Thus, only the surplus is taxable. This would mean that business, economic or market considerations would determine the norm. The taxing authority declines to go behind the profits earned in the base period and to investigate if that income was not in itself either too much or too little. The accruing profits may be determined under varying economic conditions of competition, combination or monopoly operating in different degrees in different types of enterprises and concerns. But none of these forms the basic consideration. This leads to another feature of this method, namely, individual variations of the norm. The standard amount would differ not only as between different types of undertakings but as between different firms; thus, there would be as many 'normal' levels as there are assessees.

This method of arriving at the norm has many limitations. To start with, it cannot be applied to

all concerns but only to those which existed in the pre-tax period. It is not also applicable to concerns which have undergone fundamental changes since the tax was levied. This drawback led in the United Kingdom, the United States of America and other countries to the adoption of the percentage and special profits standards as alternatives. The former alternative is described in detail later. Under the Special Profits Standard, where a business is very recent or has invested considerably since the tax was levied and has not, therefore, a correct basis of pre-tax profits, the profits of other firms in the same industry or of any other business that the owner was carrying on was allowed as the norm. This was the practice in the United Kingdom while in the United States of America "representative firms" were resorted to under the 1917 law. Obviously these methods of overcoming the limitation are themselves defective. Apart from the difficulty of getting at a "Representative Firm," average profits in any industry would be inequitable to the sub-average firms. There is no justification for giving a new firm more than what is given to a sub-average firm, without a knowledge of the real profit-earning ability of the new firm or the new investment. Similarly, there is no rational connection between the profits of a business which the owner was carrying on before the levy of the tax and the current taxable undertaking. An entrepreneur may change his business simply because the old one was not paying and, therefore, may legitimately be entitled to higher profits than he was making previously.

In addition to the limited scope of the base period norm, the second drawback is the difficulty of getting a true base period. There are three methods of arriving at the accrued profits norm. First, the *choice* of *one year as the universal base*. Among the ups and downs of prosperity and depression, any year regarded as normal may set the standard of profit. The profits accuring in that year to different concerns become the norm for each irrespective of whether a

particular undertaking was lucky or not in that year. This is the simple procedure adopted in the construction of any type of index number. The base year need not be the one immediately preceding the tax year but may relate to any previous representative normal year. Thus in constructing his index number of industrial profits [25] Josiah Stamp has chosen 1924 as the base because, among other reasons, it has been adopted for so many other sets of statistics and was in itself perhaps the best nodal year since the war. It is immaterial what the year is, but one year is taken as setting the normal return necessary to maintain the investment and enterprise. It may be pre-Great War year or pre-Depression or post-Depression year, say 1935-36. The more recent the year, the better would be the base since it would be more representative of the methods of production in the taxing period.

The defects of this base are obvious. No one year can be normal for all types of enterprises. The fortunes of concerns are fluctuating and such fluctuations are by no means uniform in all cases. Only when we consider economic activity as a whole can we speak of depressions and booms and "normal years." But in determining excessivity of profits it is misleading to consider any one year as normal for all businesses. A look at Table V in Chapter III quite clearly points out the differing normal years in different cases. It is, however, theoretically possible to *assume different years as bases* for different types of enterprises. But they will have to be legion, as many as there are varieties and subvarieties of enterprises, and the drawbacks of such a procedure are plain. Thus, for instance, the British shipping interests pleaded [26] for any three consecutive years, at the taxpayer's option, from 1927-37, while *The Economist*

25. *J. R. Sts.*, 1932.

26. *The Economist* 8th May, 1937, p. 447.

perferred two years from 1933-36[27]; but the Federation of British Industries urged the inclusion of 1938 in the base period.[28]

A practicable modification of *the series of base years concept* was put into operation during the First World War. This consists in taking a few *pre-tax years as normal* and allowing the assessee to pick out any of them as his norm. The underlying assumption is that the period 1910-14 and especially 1913-14 for the levy of the tax during the First and the years 1935-39 during the Second World Wars were normal. All revolutionary changes in methods of production and marketing had ceased, especially in 1910-14; demand for goods was static since the world market had been divided among producers; political upheavals were not anticipated, large-scale wars were thought impossible; a kind of competitive individualist society was regarded as having been permanently and finally established; and, in short, economic equilibrium had been achieved and it looked as though a static society had come to say.

This modified practice may obviate some defects but is not free from drawbacks of its own. A series of three years or even four is insufficient to provide the true basic norm for dozens of enterprises.[29] "If we take only the income of two are three years before the war", wrote the American Treasury Expert of the 1914 war[30], "there is no necessary correspondence between such income and the true capital of the business. But what chanced to happen in the three years which preceeded the outbreak of the war is not and should not be the controlling factor in this connection. Even if we accept the pre-war standard, its logic requires that we ascertain pre-war earnings over a sufficient number of years to obtain a true or normal average." Further,

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27. *Ibid*, also 24th April 1937, p. 447.
28. *Ibid*, 20th January 1940, p. 98.
29. *Supra* ch. III.
30. *Annals* Vol LXXV, P. 152.

the equity, but not the generosity, of allowing a firm to choose its own base year is not beyond question.

A third variety of determining the base period profits is to resort to *an average* (*of any kind*) of accrued profits for a number of pre-tax years. As T.S. Adams has suggested [31] it would be theoritically possible, for instance, to take the income for a considerable number of years, exclude the abnormal years and accept the remaindar as our datum line. This would even out changes in profits. Thus, in the United Kingdom the *general* rate of profits in the years 1912-14 was 100, 108 and 94 respectively and averaging the profits would iron out fluctuations and give us a sort of norm. Sometimes, if a concern has had an abnormally bad period during the general base period, the number of years for averaging purposes may be extended, *e. g.*, in the United Kingdom the average of four out of six pre-1914 years was allowed. Again, where the war period is short, *e. g.*, in the case of a new firm, the average or even the profits of the year or years for which data are available have been allowed.

Averaging is no doubt the least inequitable of the methods of arriving at the standard profits. But it suffers from all the drawbacks which affect the Income Standard itself. I have already pointed out how this standard is restricted in its application and how there is difficulty in arriving at the base profits. A further objection is that a comparison between this normal level and the current profits may indicate the deviation of profits from the base but it cannot point out whether the base period profits themselves were not too much or too little. "It should be realised," complained the *Economist* [32] "that companies which were making excess profits during the war have not paid a penny of E.P.T. It is not, infact a tax on excess profits but on rising profits." As in the case of the American automobile industry, the extraordinarily large profits in the past should not exempt a business

31. *Ibid.*, 156.
32. 17th March 1945. 334.

from a future tax on super-normal profits. For, an abnormal state may continue for a considerable time without becoming normal, as for instance in the case of the jute industry in India.[33] Immunity from taxation should not be granted to a concern simply because it had been successful before the new tax was imposed. Similarly, a firm must not be condemned to low profits merely because it was unfortunate for a time and had to wait long to make up the low profits. "Consider a heavy investment made in the expectation of heavy returns. Here the original investment has more significance than the income record of the company in controlling the normal return."[34] As the *Economist*[35] observed in 1937, "there is the real danger that it may press unfairly on firms which are struggling out of the depression, or businesses which have made headway in recent years by special enterprises." "For example, shipping, the cotton trade, the trades of the Depressed Areas, the new industries of this country which have been absorbing the employable population, will be hard hit."

Further, the Income Standard ignores the invested capital and does not provide for variations in it. Expansion or contraction of business capital is common in economic activity. The pure Income Standard assumes that trade in the taxing period is along old lines and that there is no new plant or equipment or no change in methods of production or marketing. There would thus be a penalisation of concerns which were in the process of development before the tax-period and of foresight.[36]

There are other difficulties also, though they are of minor importance. Thus, there may be changes in the meaning and significance of profits between the base year and the taxing year. This drawback,

33. *Supra* Ch. III.
34. *Q.J.E.*, 1921, p. 388.
35. 24th April 1937, p. 190.
36. *Vide* the cases of Aircraft Components and Settle Limes in Great Britain (The *Economist* 2nd November, 1940, P. 552).

however, is minor since such changes may occur in the course of a decade or more, but not in the very short period separating the base and taxing years. Moreover, the defect holds good in the case of all assessees and, therefore, is not discriminatory. There is also the difficulty arising from the merging or separation of concerns between the two years involving the question : Should thc profits in the base year be added up for exemption purposes, or divided, and if so, in what proportion in the case of separation of one business into two or more independent units? These problems, however, are questions of detail and there are not generally many such cases, but where they arise could be solved with the help of an efficient administrative staff. A similar question crops up in the statement of losses in two or more concerns under one management. In U.S.A. the losses in one were allowed to be made good by the profits in the other and only the net total was liable to taxation, whereas in the United Kingdom each business was dealt with separately. The latter appears more equitable but these difficulties are inevitable under the Income Standard.

The fundamental limitation of the pure Income Standard is the inequity of applying a static standard to dynamic conditions of investment. In the words of the *Economist* " Even as a measure of war profits, the crude comparison with pre-war earnings is growing progressively less accurate and will soon he wholly misleading.[37] " Something much more flexible than EPT has proved in the past," observed the same authority elsewhere,[38] "is required to assist in the direction of the flow of savings, private and corporate, into the right channels and to determine the right choice between capital re-equipment and consumption goods at the various periods of readjustment. And there seems to be no reason to modify the general

37. 29th Sept. 1945, p. 442.

38. *Ibid* 6th November 1945, p. 264.

principle that a tax on excess profits, when excess is defined solely or mainly by reference to the experience of the past, is a thoroughly bad tax for peace time use." This defect leads to a modified plan. The amount of base profits is still regarded as primary but adjustments are made for changes in invested capital. There is no computation of original capital, and on this the normal return is the profits in the base period. Additions to and deductions from the original investment after the levy of the tax are provided for separately in the form of a percentage return. Thus during the 1915 levy of the tax in the United Kingdom normal profits for increase of capital were 9 per cent. for corporations and 11 per cent. for non-corporate businesses, while 8 per cent. and 7 per cent. were allowed for decrease of capital in the two cases respectively, and in the 1940 tax it was 6 per cent. The discriminatory treatment of the two types of businesses was based on considerations such as provision for salaries but the question may be deferred here.[39] It may be noted how the assessee was allowed a higher percentage in the case of increase than was deducted in the case of decrease of capital—both ways the law favoured the tax-payer as against the state.

This modification is a half-way house between the pure Income Standard and the Capital Standard described below, and, therefore, has some of the defects and merits of both methods. As in the former standard it exempts some high profits *simply because* a firm enjoyed them before the imposition of the tax and thus discriminates between firms and between industries.

THE CAPITAL STANDARD

A major alternative to the Income Standard differing from it radically is the Capital Standard.[40]

39. *Infra.*

40. T. S Adams (*Annals*, Vol. LXXV, p. 152) believes that as a matter of theory and in the average or normal case, these two standards—the income-standard and the capital standard—are essentially similar, largely on the ground that the real invested capital depends upon normal earnings. The questionableness of this view is obvious from the analysis below.

This alternative method brushes aside the amount of accrued profits as the true criterion of normality. What has been enjoyed need not

Features

be what ought to be enjoyed. Accruing profits may aid the discovery of, but cannot themselves be, the true norm. An altogether new datum line is necessary, because only in a static business world can the pre-tax income be the true criterion. So long as the business world is dynamic and semi—or fully monopolistic, past profits cannot represent the non-taxable minimum. Otherwise, there would be discriminatory treatment of the different tax-payers. A *de novo* fixing of the norm is necessary in the interests of justice both to the competing firms and to the revenue receiving State. For, even granting that each assessable firm was receiving what it would get in a static state, some or all of them may be getting more than is socially desirable, *e.g.*, monopoly gains. Therefore, the Capital Standard holds out for a legislative norm as against the accrued profits norm of the income method. Secondly, the *amount* of profits is not so important as the *rate* of return on the capital invested and must thus be related to the varying investment, risk, etc. Finally, norms should differ according to different groups of enterprises and not according to individual firms as in the Income Standard. The latter emphasises particular experience and individual norms but the former stands out for a general norm and group minimum.

The Capital Standard is not without drawbacks. First, it is bound to be arbitrary both with regard to the norm and in the evaluation of

Limitations

invested capital to which the norm is applied. However detailed and careful the investigation and whatever provision might be made for the conjunctural and dynamic factors, it is impossible to evolve perfect norms to suit the various types of enterprises. A certain amount of inequity is inevitable. But such inequity and arbitrariness are unavoidable in any kind of tax. Even in the income

tax, which is regarded as the justest of all imposts, arbitrariness in the exempted limit and in the rates and slabs are present. It is inherent in taxation itself. Another limitation of this standard is the inconvenience and expense involved in determining the norm and applying it especially in estimating the amount of invested capital. The weighing of the various factors affecting the exempted profits of each type of enterprise is troublesome enough but much more so would be the enquiry into the manifold elements comprising the capital of each individual enterprise. But given an efficient staff like the Inland Revenue Department in the United Kingdom these difficulties would be fewer than they appear. In the words of *The Economist*[41] the accountants do not regard the assessment of capital as an unsolvable problem, although to assess the capital of all important concerns in the country on standard principles is a tremendous undertaking full of pitfalls and anomolies. Some of these difficulties and anomolies have been discussed later. A further defect is the great responsibility and power that the administrative staff will have in making the tax a success. For, it is impossible either for the legislature or for a court of law to determine the normal rate and the invested capital in each and every case. These matters of detail must be left, as was done in England and other countries, to the staff ranging from the surveyor to the Board of Referees. It is, however, difficult to find in all countries the same efficiency and disinterestedness in the administrative staff or the same trust and confidence of the public in the staff as is found in the United Kingdom. This limitation, however, applies to all taxes and must gradually be overcome by education and training of the staff as well as the tax-payer.

On the whole these drawbacks are superficial compared to the fundamental fairness of the excess profits tax itself and of the Capital Standard. For

41. 24th April 1937, p. 190. Also *Ibid* 26th January 1946, p. 142.

the normal rate must depend upon economic needs and social considerations. To achieve the ethical purpose of the tax, to make it an instrument of national planning, and to bring about equity of return between types of enterprises and among different firms, the Capital Standard is preferable to any other. That is also the only way "to introduce sufficient flexibility into the administration of a profits tax to enable it to conform fairly satisfactorily to the complex conditions of modern business."[42] "The best British opinion," concludes R.M. Haig,[43] "supported the view that a percentage on the invested capital is a more satisfactory test than the earnings of some previous period in a tax of this character, and they have shown how that percentage can be cleverly made to meet the peculiar condition in each line of business."

Under the Capital Standard two main methods of fixing profits allowable free of tax on the invested capital are available—one, the utilisation of base profits themselves and the other, an independent determination. The former may be called the *base period percentage* and the latter, the *statutory percentage.*

Base period percentage

The simplest form of the first type is to regard the profits of a concern in the pre-tax period as the normal percentage return on the capital. Instead of viewing the pre-tax gains as an absolute amount, they may be taken as a rate applicable to all present and future capital. This was the procedure adopted in Italy during the 1914 War and in U.S.A. in 1937. The merits are obvious. Administratively it is most convenient. It also provides for all factors influencing profits such as risk, personal equation and varying abilities of the entrepreneurs, since it assumes as the normal rate the profits accruing to each tax payer in a natural economic equilibrium resulting from the operation of

42. *Report on the Taxation of Excess Profits in Great Britain*, p. 133
43. *Ibid.*

economic forces. But the defects of this procedure are overwhelming. In addition to the drawbacks associated with the Income Standard, it not only perpetuates discrimination between individual firms but extends it to all future capital. Thus, a firm which unfortunately has had a patch of adversity in the pre-tax years is condemned to a depressive rate while a lucky one is confirmed in its luck. How undependable as a norm the actual profits are is evident from the course of profits during 1918–39.[44] The adoption of this method would vitiate the very purpose of the tax and result in unfair individual weightage.

This defect of individual weightage can be overcome by a slight modification of the procedure. The accruing *average profits in an industry or region,* instead of the gains of a particular firm, may be allowed as the normal percentage. This method was not applied anywhere for old firms *i.e.,* those existing in the pre-tax period, but was applied to new ones and to those which did not have the required number of pre-tax years to their credit; *e.g.,* in U.S.A. new concerns of less than a year's standing were allowed the median average in the industry during the base year and not less than ten per cent. In the case of new industries in Canada, the standard profits of the same or analogous class of business were resorted to.[45] Although this modified procedure is less objectionable since group weightage is substituted for individual weightage, it has its limitations. The major objection that the pre-tax profits differ very widely among the occupations according to the nature of the market would hold good, even if a very long period of 20 years is taken into account.

Another kind of modification of this method is to consider the *average profits of all types of enterprises* as the norm. There would be neither individual nor group weightage but one uniform rate of profits

44. *Supra* Ch. III.

45. *The Canadian Excess Profits Tax Act,* 1940, Section 5.

allowed for all types and all firms. This method was not in use anywhere. Apparently it is satisfactory but really it has its limitations. There is the administrative defect, *viz*-, the trouble and expense of computing invested capital and aggregate profits but this is not of much importance; for, whatever the form of the percentage method adopted, the trouble and expense will persist. The real objection is one of principle. Normal rates of profits must differ between industries because of the differing conjunctural elements which must be provided for. A highly risky enterprise like film production cannot be put on the same level as iron and steel; nor can the exhaustible oil and coal mining enterprises be treated in the same way as cotton and jute. Provision for these special factors—described in detail later—necessarily involves differing norms.

Statutory percentage

Although none of these sub-types of the base period percentage method is satisfactory, base profits may be used as a factor influencing the normal rate determined *de novo*. This alternative method was used during the 1914 War. Thus in the United Kingdom the statutory percentage was fixed at rates varying from 6 to 11 per cent. *plus* additional percentages allowed on appeal. In the United States of America the normal percentage was 8 while in India it varied from 8 to 10 per cent. In Germany it was, according to the law of 1916, 6 per cent. of the capital invested. Similarly in other countries. Even under the 1940 tax, this method was used, though to a lesser extent.

The Three Factors

Normal profits must be fixed under three heads—the *basic rate*, the *standard rate* and the *effective rate*. The basic rate distinguishes loans from investments. Resources could be merely loaned e.g. a depositor in a bank; the holder of debenture bonds in an individual concern; or the owner of the liquid funds might have initative and invest them in shares, thus becoming a risk taker. These two uses of resources should be distinguished, and the

'investment aspect' encouraged. Hence the basic rate provides the irreducible minimum for any enterprise. The *standard rate*, described in detail later, provides for flexibility between *types* of business or regions. The opportunities, ability and desirability of different kinds of enterprises in earning profits differ considerably. Thus a key industry may be entitled to a higher rate of normal profit than a luxury enterprise,—*e.g.* heavy chemicals versus manufacture of face powder—both in its own right and in social interests. Or, territorially, a particular industry may need development in a particular depressed or undeveloped region and a higher standard rate for *that industry as a whole in that region* may be necessary. Thus *industrial and regional flexibility* is provided for in the standard rate, which is similar to, though in effect different from, the standard rate in income tax. The effective rate, also described in detail later, provides for *entrepreneurial flexibility* i.e. differences in the abilities of the different entrepreneurs and in the efficiency of the individual concerns, so characteristic of business and so important for progress. The effective rate may differ as between different firms and should be fixed so as to retain the incentive to efficiency.

Basic rate

Two factors aiding the determination of the basic rate are the prevailing rate of interest and the average rate of industrial profits. Neither of these, however, can give even a fair basic percentage which must necessarily depend upon arbitrary determination.

The following factual analysis relating to the rates of interest is interesting:

TABLE XXII

Rates of Dividend and Interest—1918-39

(United Kingdom)

Year	Bank Rate (average)	Consols	Debentures	Dividend	
				Preference	Ordinary
1918	5·0	4·4	....	....	9·9
1919	5·1	4·6	4·4	5·2	11·0
1920	6·7	5·3	4·3	5·2	11·9
1921	6·1	5·1	4·5	5·2	11·8
1922	3·7	4·4	4·7	5·1	8·6
1923	3·5	4·2	4·9	5·4	9·0
1924	4·0	4·3	5·0	5·3	9·5
1925	4·5	4·4	5·0	5·5	9·9
1926	5·0	4·5	5·0	5·5	11·1
1927	4·6	4·5	5·1	5·4	11·0
1928	4·5	4·4	5·1	5·5	10·5
1929	5·5	4·6	5·1	5·6	10·3
1930	3·4	4·5	4·9	5·9	10·3
1931	3·9	4·4	5·0	5·4	8·4
1932	3·0	3·8	5·0	4·9	5·7
1933	2·0	3·4	5·1	4·5	5·6
1934	2·0	3·1	4·8	4·6	6·1
1935	2·0	2·9	4·7	5·0	7·1
1936	2·0	2·9	4·5	5·2	7·9
1937	2·0	3·1	4·5	....	9·0
1938	2·0	....	....	..	....
1939	2·3	....	....	...	....

The Bank rate is the main influence on other rates of interest in the market. It is *generally* the lowest loan rate, because there is little of uncertainty for which it is a payment and is largely affected by

the condition of the money market and of general economic position. Its lowness and comparative steadiness in the United Kingdom during the period under consideration is noteworthy. Like the Bank rate and depending upon it as well as on the stability of the concern floating the loan is the debenture interest rate, which is essentially a return for the loaning of capital, with very little of the element of uncertainty involved in it. It may be observed from the foregoing table how steady the average rate has been for debentures. Throughout the twenty years it has been about 5 per cent., the actual average being 4·8. The limits of variation have been 4·3 and 5 per cent. Of course, the variation has been very much larger when the different types of enterprises are considered. Thus the highest average rate of debentures has been 7·3 in 1923 in Nitrates and the lowest has been 3·1 in 1918 in Canals, Docks, etc., while greater variation is found when individual concerns are considered. The great variations in the rates of interest on debenture capital as between different years, different types of enterprises and different concerns themselves are largely influenced by the condition of the money market, especially the competing issues and the bank rate and the confidence of the lenders in the stability and profit making ability of the debenture raisers. But, two conclusions stand out from a study of the rates of interest; firstly, that the average debenture rate has followed the bank rate and secondly, that it has steadily continued to be at the low level of 5 per cent. It may also be noticed that the yield of the Consols has rarely exceeded 5 per cent. but has been round about 4 per cent.

Similar to the debenture interest but with more of the element of risk and uncertainty is the preference dividend. The preference shareholder is an investor undertaking risk to a limited extent. Although liable to share the loss along with the ordinary shareholder, yet he differs from the latter in so far as he has the first claim on the profits and assets of

the company, so that he does not bear the risk to any extent comparable with that of the other. Further, he resembles the debenture holder in so far as the rate of return on the preference capital, though to some extent varying with the fortunes of the concern, is practically definitely limited. The rate of preference dividend in the United Kingdom has been, like the debenture interest, both low and steady, almost closely following it up. Thus the average rate of preference dividend has been 5·3 per cent. and the variation in the different types of concerns has been very little, though the extremes have been in nitrates which declared a rate of 13·4 in 1918 and nil in some other years. This, however, is an exceptional case. The representative, though not the average, rate has been about 4 per cent. Thus, as in the case of the rates of interest, so in the case of the preference dividend the natural inference is that the rate is low as well as steady.

With this might be compared the rate of dividend on equity shares. It is inevitable that the ordinary risk takers must have their share of the gain according to the fortunes of the company. Consequently, some amount of variation in the rates is noticeable as between the different years and as between the types of concerns. But the variation in the average rate of profits for all the concerns has been between 5·6 per cent. and 11·1 per cent., the average for the whole period being 9 per cent. The highest average for any one type of undertaking has been about 12 per cent.

Similar trends can be noticed in the data relating to India:

TABLE XXIII

Rates of Dividend and Interest

(India : 1918-39)

YEAR	Declared Dividend (Ordinary)	INTEREST			
		Yield on $3\frac{1}{2}$% Govt. Security	Average Bank Rate†	Municipal Loans‡	Government Loans§
1918	30·0	5·3	5·9	....	....
1919	26·0	5·0	5·9	5·5	5·0
1920	29·0	5·9	6·2	5·2	....
1921	20·5	6·2	5·5	6·7	....
1922	19·6	6·4	3·8	7·0	....
1923	12·6	5·7	5·9	6·5	....
1924	12·8	5·2	6·6	6·2	....
1925	12·0	5·5	5·6	6·1	4·7
1926	12·5	4·7	4·8	6·5	5·0
1927	13·5	4·4	5·7	....	4·0
1928	12·5	4·6	6·1	5·0	4·2
1929	12·5	4·9	6·2	5·0	4·5
1930	9·5	5·1	5·8	6·0	4·0
1931	8·7	5·5	7·0	6·1	4·0
1932	9·1	5·7	5·0	6·6	4·7
1933	8·3	4·8	3·5	4·1	3·8
1934	8·9	3·9	3·5	3·5	3·0
1935	7·4	3·5	3·4	3·1	3·0
1936	7·6	3·6	3·0	....	2·8
1937	9·5	3·5	3·0	....	....
1938	10·8	....	3·0	....	....
1939	6·5	....	....	....	....

† *Vide* S. K. Muranjan *Modern Banking in India*, p. 72. Strictly, the 'bank rate' in India begins with the establishment of the Reserve Bank.

‡ Average rate relating to loans raised by Bombay, Calcutta, Madras and Rangoon.

§ Average Rate.

The average bank rate for 20 years in the United Kingdom has been 4·1 per cent. and in India 5·1 per cent. These may be taken as the *minimum rate* of return allowable to all concerns in the respective countries. The basic rate of profit must necessarily be higher since the rate at which the businessman ordinarily borrows will be higher than the bank rate and since allowances must be made for the profit element. It may be noted that the average rate of ordinary dividends for 20 years has been in the United Kingdom 9·2 per cent. *i.e.*, a little more than twice the bank rate; in India also, the average dividend for 22 years works out to 13 per cent. *i.e.*, about 2½ times the bank rate. These arithmetic averages are very near the median in both cases, *viz.*, 9·5 per cent. and 12·5 per cent. respectively in the two countries. The average rate of profits for all enterprises may be regarded as the *maximum for the basic rate*. It may be noted that the statutory percentage that prevailed in some countries during the First and the Second World Wars was between the two limits suggested above. Thus in the United Kingdom the rates allowed were as below:

	Corporate 1915-20	Non-Corporate 1915-20
1. Where percentage was optional to the profits standard	6	8
2. Where percentage was obligatory, *i.e.*, no pre-war year	9	11
3. Percentage deduction for capital increase	9	11
4. Percentage exempted for capital decrease	6	7
5. Percentage exempted where capital was unremunerative	6	9

The basic rates thus varied between 6 and 11 whereas 8 per cent. prevailed in U.S.A. and 8 to 10 per cent. in India. Under the British excess profits tax of 1940 the statutory percentage did not exceed 10 per cent. and the Board of Referees could allow, in cases where the Capital Standard was resorted to, not more than an amount of profits sufficient to pay

a dividend on preference capital. Further concessions were permitted in exceptional cases. In the case of director-controlled companies, 8 per cent. was allowed. In Canada in all cases of alterations of capital employed adjustments in standard profits were made at $7\frac{1}{2}$per cent. on such alterations [46] while in the cases of depressed industries the maximum allowed was 10 per cent.[47] Under the 1940 Indian law, the variation was between 8 and 12 per cent. [48] It may be noted that while the British Shipowners Parliamentary Committee in 1937 considered 6 per cent. as inadequate, [49] the Rubber Growers' Association claimed a return of $12\frac{1}{2}$ per cent. as a "reasonable minimum" for their highly speculative industry.[50] *The Economist* pleaded in 1939 [51] that developing or depressed industries should get at least 6 per cent. on paid-up ordinary share capital. In their memorandam submitted to the Chancellor of the Exchequer in Januany 1943 the Federation of British Industries pleaded for the grant of 8 to 10 per cent. in director controlled companies as against the current 6 to 8 per cent. on the ground of elasticity.[52]

Standard rate

The basic rate, however is inadequate in practice if the tax is either to succeed administratively or to be equitable. Conjunctural factors affect different types of enterprises differently. "If each business regardless of its nature and hazards", wrote Zoller,[53] "is permitted the same rate of deduction based upon the capital invested, the scheme will necessarily bring about inequalities, taxing some businesses upon earnings abnormal and some upon earnings that are only

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46. *The Candian Excess Profits Tax Act,* 1940, Section 4.
47. *Ibid,* Section 5.
48. *See* Sec. 6 of the 1940 Act.
49. *The Economist.* 8th May 1937.
50. *Ibid,* 22nd May 1937.
51. *Ibid,* 25th November 1939.
52. *Ibid* 30th January 1943 p. 149.
53. The War Revenue Act of 1917 (*Annals* 1918, p. 189).

normal or possibly less than normal." There must, therefore, be a *standard rate* actually applying to different groups and providing for the varying and dynamic factors affecting business, such as, the element of risk varying horizonatally among different industries and vertically in the same industry over a period of time; social desirability and personal equation. Flexibility of the normal rate applying to different industries is, therefore, a *sine qua non* of the successful working of the tax. In many countries, especially in the United Kingdom and the United States of America, great elasticity in the rates was introduced during the 1915 levy of the tax and largely accounted for its successful operation particularly in the former country. In the United Kingdom even the basic rate, *i.e.*, the statutory percentage, was elastic and varied between 6 per cent. and 11 per cent. but, as pointed out elsewhere,[54] such elasticity in the basic rate is unjustifiable. Provision for the foregoing factors must be made in the standard rate. In the United Kingdom the basic rate was fixed by law while the standard rate was determined administratively by the Board of Referees on the representation made by affected enterprises. The extra rate allowed was in some cases as high as 21½ per cent.[55]

Flexibility in rate may be upward or downward or both according to what the standard rate is but in the present case we can have only the former type since no contraction of the basic rate is possible. In providing additional rates it is difficult to anticipate all factors; each industry and even each undertaking may give rise to peculiar problems, which may vary in importance at different times. Therefore, the rate cannot be predetermined by statute without investigation but must depend upon the evaluation of and provision for new factors by a continuous process

54. *Infra*.

55. *e.g.* Gold minfng fn Egypt.

of administrative discretion. We might, however, consider below a few major and permanent influences: (1) those which must be provided for on grounds of equity, *e.g.*, risk; social desirability; ownership and control; deferred yield; co-operatives; (2) those which must be considered on grounds of administrative convenience, *e.g.*, depletion and personal equation; (3) those which have been provided for in practice but which cannot be justified, *e.g.*, where the percentage standard is optional; differentiation between corporate and non-corporate businesses; between new and old capital.

Risk

Leaving aside the interesting thesis that there is a positive risk-preference in individuals, *i.e.*, the willingness of many people to bear risks even though their mean expectation is less than the price, provided the odds attract them,[56] I shall assume that risks are generally undertaken by entrepreneurs for reward, and shall analyse below the methods of providing for the risk element. Uncertainty in business may relate either to capital or profits. The risk of depreciation and loss in invested capital differs in different industries being considerable where static risks predominate. Provision will naturally have to be made from profits to meet such a contingency. This question, however, is a part of the invested capital problem discussed later.

What concerns us here is the uncertainty relating to profits and profit-earning ability. Some businesses are steady yielders while others are highly speculative. Thus textiles and iron and steel belong to the former class and film production to the latter. Prospecting for oil is a hazarduous business, but if conducted on a scale large enough and in conjunction with other branches of the oil industry, the risk is not probably so great as those involved in operating a restaurant

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56. *Vide Speculation and Risk-Preference* by Harold Berger (*J.P.E.* 1938, p. 408).

or conducting a street-corner shop.[57] Profits are bound to be higher in a highly risky enterprise and capital will not flow into such speculative business unless it has a chance of high profits to offset possible losses. It is difficult accurately to measure risks, though it is claimed [58] that the best test of risk is a comparison of the variability in returns from year to year, and that a measure of such variability can be obtained by comparing the annual yield with the average yield for each industry.

In the United Kingdom in 1915 risk was provided for in two ways. First, there was a choice to the tax-payer between the Income Standard which, whatever its limitations, provided automatically for differing risks and the Capital Standard. Secondly, where the latter alone prevailed as in new concerns or additions to capital, increases up to a maximum of 21½ per cent. in the statutory percentage were on appeal granted by the Board of Referees.[59] In the 1918 American law, in certain cases the average per cent. of net income to invested capital on the pre-war basis of the industry was allowed, while in other cases the rates were derived from the rates of the tax-payers and the median average.

Three aspects of risks may be noticed. First, differences in risk as between classes of enterprises, which may be termed *horizontal variation*. One test of this element is steadiness or unsteadiness of profits earned. An analysis of dividends in India, the United Kingdom and the United States of America gives useful indication relating to the variability between industries.[60]

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57. *Q.J.E.*, p. 1921 p. 381.

Because of this factor, the Canadian Act of 1940 made special provision for gold mines and oil wells and followed the principle of persumptive production and selling price (*vide* Sec. 5 A of that Act).

58. R. S. Tucker; *Is there a tendency for profits to equalize ? A.E.R.* 1937, p. 521.

59. Haig, *op. cit.*

60. *Supra* Ch. III

The additional percentages granted during the 1915 levy of the tax in the United Kingdom indicate that the enterprises deserving special concession are mining, gold, tin, antimony, chrome, manganese and oil in the descending order. Enterprises connected with necessaries are obviously less fluctuating in fortunes. Apart from the nature of the enterprise, the *place of operation* appears to affect the fortunes of a concern. For example gold mining in British India and Egypt was allowed 21½ per cent. extra whereas that in Columbia only 9 per cent. Generally enterprises at home are steadier though less profitable than those abroad. The effective rate of normal profits must thus provide for horizontal variability of risks. No general rule can be laid down regarding this extra grant. Each case must be considered separately by an administrative body of experts.

The second aspect of risk is the *element of time* giving rise to *vertical variation.* Some industries are affected by short period risks and others may be prosperous in the short run but influenced by long period risks. Depressions and booms affect all enterprises but in different degrees, thus requiring greater concession to be shown in depressions and to the specially affected industries. A general solution for the time factor is the averaging of risks. "In the main, the risk element," wrote Adams,[61] "should be eliminated by averaging losses and subnormal profits over a period which should be at least three years in most industries and less than 10 years in some industries." By smoothening out profits, the loss of a previous year can be made good by the profits of the next. Such a striking of a true balance of gain and loss is a condition precedent to the fair and successful working of the profits tax. The principle of averaging was followed in the United Kingdom and the Harrison Committee on industrial risks supported it. It is doubtful if risks can be accurately averaged over a period, and, if they can,

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61. *Q. J. E.*, 1921, P. 390.

what the length of such period should be; but a considerable amount of unfairness arising from the time element can be avoided by averaging returns; and this problem is discussed elsewhere.[62] No provision need ordinarily be made for this factor in the standard rate of normal profits.

A third aspect of risk is the *element of size, i.e.*, the problem whether risk increases proportionately or progressively with the growth in the size of investment. No doubt, the amount at stake increases with the increase in the invested capital but it is equally true that the ability to bear and avoid risk also increases at least proportionately to the investment. In fact, one reason for amalgamation of firms is such a reduction in risks consequent on the growth in size. There does not, therefore, appear to be any justification in principle for discrimination in the standard rate on the basis of size or investment.

Social desirability[63]

There is another factor influencing the standard rate. Economic fullness and self-realisation of a nation demand the optimum and balanced mobilisation of her resources; but on account of various factors—external and internal—there may be an unbalanced development of occupations. Thus, basic industries may not have developed to the extent desired, while luxury industries may be overdeveloped. One of the ways of bringing about balance is variation in the profit rate. A higher standard rate, say, to basic industries, would stimulate them while a lower rate would discourage them. Once the need and importance of particular types of enterprises is decided upon by the planning authority, adjustments in the rates of profits would help the execution of the plan. As in the case of the National Defence Contribution the tax can even be remitted in whole or part if such a concession was necessary for establishing particular

62. *Infra*

63. *Infra* Ch. V. for a detailed discussion of the EPT and planning.

industrial undertakings. Under the Canadian law of 1940 base metal and strategic mineral mines were exempt from the E.P.T.[64] The same remarks are true of territorial distribution of industries, and variation in the standard rate may be made an instrument of regional planning.

Ownership and control

Another influence that may affect the standard rate is that of ownership and control. The provision for this factor depends not so much on general equity as upon the policy of the state. In some countries like our own a great deal of foreign ownership and control is found in some types of enterprises and many industrial firms. It is a broad question of public policy whether such a state of affairs is in the interests of the country. But assuming that it is not and that, as in some other countries, nationals only must control and own investments, one of the many methods of giving effect to such discrimination is the variation of normal rate, *i.e.*, allowing enterprises and industries run by nationals a higher percentage of normal profits. This would achieve in another way the same object as the insistence upon rupee capital, representation of nationals among the shareholders and the directorate, etc. The variation of the standard rate on this ground would involve, not discrimination between types of investments, but the more minute discrimination between firms and perhaps will have to be adjusted to the varying degrees of external ownership and control. Such a step would involve detailed investigation into each firm but it appears administratively practicable, since all additions to basic rates will necessarily involve a detailed consideration of the position of the particular industry. I, however, feel that this factor involves unpleasant discrimination and had best be dropped, since there are other methods of achieving the same object.

64. *Canadian Excess Profits Tax Act*, 1940, section 7 (9).

I have already pointed out how these institutions, being for private benefit, cannot claim exemption from the tax itself. But equity demands treating them more generously than the proprietory organisations. For, these societies are not for exploitation but for prevention of exploitation of the members. It is in social interests that they should prosper and expand. A more generous standard rate would certainly give them a fillip, but the relative importance of this factor in norm determination depends on the extent to which the co-operative movement either needs or deserves encouragement.

Co-operative Societies

Other grounds of discrimination in normal rates of profits have been in operation in different countries, a few of which are discussed below to indicate how inequitable they are. The first is discrimination according to the obligatory or the optional nature of the Capital Standard.[65] Thus during the 1915 levy of the tax in the United Kingdom a higher basic rate, *i.e.*, 3 per cent. more, was given where the Capital Standard was obligatory and a lower percentage where it was an alternative to an Income Standard. The inequity of such discrimination should be obvious, for, if the actual profits were higher than the statutory rates, they ought not to be allowed in any permanent tax as the Income Standard is in itself indefensible, while, why any concern should suffer or get an advantage merely because it has a pre-tax existence is hard to follow. Such a discrimination is perhaps permissible when the tax is levied temporarily during an emergency, since a higher percentage might induce new concerns to be started in troubled times.

Other Grounds of Discrimination

Another basis of discrimination was between *capital increases and decreases*. While in Canada, the same rate of $7\frac{1}{2}$ per cent. was allowed for increase or decrease of capital, in the United Kingdom,

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65 *Supra*, p. 158. See Section 6 of the *Indian E.P.T. Act* of 1940.

capital increases during the war were given 9 per cent. *i.e.*, 3 per cent. more than old capital, on the ground that capital invested since the emergency should be given a greater allowance than that invested in peace times. hatever the justification may be during war periods—the need for a greater incentive to capital investment or the difficulty of getting capital—in normal times when the tax is permanent, such grounds are inequitable. It would be impossible to adjust the allowances according to the varying difficulties of raising capital or the tightness or ease of the money market or even according to the varied abilities of the concerns in floating loans.

Some other considerations put forward by business are not very important. In the case of deferred yield the system of averaging profits over a six-year period would adequately provide for postponed enjoyment of profit, but where the period of postponement is longer, the Board of Referees or other appellate authority might consider such cases as also those of developing and exceptional businesses and those in the process of extensive reorganisation. Some of these considerations would be provided for in the calculation of running cost and of invested capital.

These and many other factors would arise in the actual administration of the tax and must be solved as they crop up. It is impossible for any tax to operate with complete equity on all sections of business, but the adoption of the principle of beneficent discrimination would smoothen the difficulties.

It is sometimes claimed [66] that elasticity in normal rates must also be based upon individual needs, perhaps on the ground that the risk is mainly in the first few years. As Tucker observes [67], " After the first hurdle the tract is comparatively clear. . . . . A going

66. *Q. J. E.*, 1921, P, 382.

67. *Is there a tendency for profits to equalize ?* by R. S. Tucker (*A. E. R.* 1937, P. 521.)

concern in a risky industry may be less risky than a new one in a less risky industry." Thus, a new concern is expected to get a higher exemption than an old established one. This policy of allowing a higher percentage to new concerns was followed in the 1940 excess profits tax practice. For instance in India, businessess started after July 1938 were given two per cent. extra. In abnormal times discrimination between old and new firms may be unobjectionable but under normal conditions, individual discrimination of this variety is dangerous since inefficiency among producers and graft among tax officials might be encouraged, while at the same time it is inequitable to the older firms. If it is in social interests that an industry should expand, it could be done by a higher percentage to the type as such, which will certainly mean the starting of new concerns as well as the expansion of old ones.

The effective rate

What is applicable in practice is the *effective normal rate.* The basis of profits and progress is the varying entrepreneurial abilities. The differences in ability must be rewarded and thus arises the need for incentives to efficiency. Such an incentive is partly found in a flexible effective rate of normal profits. The factors differentiating one type of enterprise from another are provided for in the standard rate for each type. But within the group different degrees of efficiency of the firms must be rewarded differently. Otherwise stagnation, in addition to inequity, will result. Further inefficiency, if treated on a par with higher ability, might lead to over-capitalisation. In fact, the fear of such over-investment of funds under a Capital Standard has been one of the objections to its adoption.

Efficiency implies minimum investment and maximum output. An entrepreneur often keeps by his idle and surplus funds in the form of low yielding assets such as bank deposits and real property. He uses the minimum capital in terms of the output, and it is only a less efficient captain of industry that

employs a larger investment per unit of return. Therefore, if no discrimination is made between the enterpreneurs on the basis of their efficiency, over capitalisation in the form of the transfer of idle or low yielding resources to the industry in question or of too high a proportion of capital formation going into forms that do not increase productivity and too little into productive equipment will become inevitable. It is thus absolutely necessary to prevent over capitalisation and to introduce entrepreneurial flexibility in the effective rate of exempted profits.

A rough attempt to control profits in this direction, though altogether for a different purpose, was made in Great Britain during the II World War in the government contract policy.[68] The government tried to negotiate a reasonable price with each supplier, the test of reasonableness being the level of cost and profits in each individual case. For a single unifrom price for the same article there was substituted a differential price for each individual producer, with the least efficient getting the highest price and the most efficient the lowest. Prices, instead of being determined by the marginal or the representative cost, depended on the government view of reasonable profits in relation to costs. This set aside *ab initio* the essentials of a free market, and the government did this to maintain the contractor's incentive to efficiency. At the outset, profits were generally measured by their relation to costs. On account of administrative difficulties and patent inequity, turnover was replaced by capital employed as the basis of profit measurement. In the beginning the basic rate of profit was fixed at $7\frac{1}{2}$ per cent. as being in line with E.P.T. but later raised to 10 per cent on capital.

The capital employed formula was a second departure from ordinary business practice. The industrialist thinks in terms of the job on hand and

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68. *The Economist*, 29th June 1946 pp. 1054 and ff. I have closely followed the Journal in the explanation of this policy.

not in terms of capital, especially as defined arbitrarily, valuing fixed assets at cost minus depreciation and disallowing goodwill and sundry other items. The government was aware of the defects but could find no alternative. The business world perceived that this formula implied that total profits (assessed as a percentage on a relatively fixed capital) would be stable or virtually so despite a steadily rising output—unless and until more capital had to be employed to sustain it. To the averge businessman this meant that the more work he did the less would be his profit—measured on the volume of business.

It was soon perceived that something more than virtually fixed return upon capital was imperative to preserve any real incentive. "A new principle was gradually evolved whereby the 7½ per cent on capital was conceived as a basic minimum target, with additional payments to remunerate contractors for more than average efficiency or for assuming more than average risks."

The formula was 7½ per cent on capital employed plus upto 2 per cent. on turnover (at cost value) as special payment for efficiency plus up to a further 2 per cent also on turnover in payment for risks assumed. Efficiency was arbitrarily assumed, having regard to past performance, relative level of costs, volume of output, flexibility, promptness in deliveries, proportion of spoilt work and so forth. *Risk* meant the extent to which the contractor was at risk on the price payable under the contract. The risks of producing the different kinds of goods were assumed to be the same. The rate worked out as below :—

7½% on capital
+2% efficiency and cost rating
+2% rapidity of turnover

11½ with maximum ratings and one turnover per year

19½ with maximum ratings and three turnovers.

Later, an overall maximum of 15 per cent on capital was instituted but even this was not rigid.

In 730 cases involving £280 m. of capital and £350 m. turnover, the average profit rate was 9·68 per cent on capital. Average actual profits of the order of 23 per cent and higher in individual cases were regarded by the Treasury as reasonable though the ceiling was 15 per cent.

A similar attempt but without the formulation of any basic principle was made in the administration of the E.P.T. during the First and Second World Wars. The Board of Referees in England—and a corresponding body in other countries—could be approached in special cases and a higher rate of normal profit, if justified, was allowed.

Neither of these attempts was fully satisfactory. As the *Economist*[69] put it "The problem is still far from a final solution and principles which may appear reasonable under war-time conditions may not be well adapted to peace-time." It is, however, possible to suggest a basic formula to provide for differing abilities of entrepreneurs.

Entrepreneurial ability or industrial efficiency can be viewed from two angles—that of society and that of the business man. The former emphasises labour productivity and, as Rostas does,[70] efficiency is measured by production per head. The famous analysis of P. H. Douglas[71] and the Cobb-Douglas formula[72] relating to the production function follow the same line of approach. This may be useful when comparing productivity between two countries or between two points of time in the same country. But as a measure of differing entrepreneurial ability between two firms in the same industry it is not

69. 29th June 1946.

70 *E. J.* 1943.

71. A number of analyses have been made by P. H. Douglas, and others jointly and severally, of which the following are a few recent ones: Douglas *The Theory of wages. Q.J.E.* 1940 pp, 399-428; 1941 pp 198-29 ; *J.P.E.* 1942 pp. 595-602 ; *J.A.St.A.* 1943 pp. 178 and also see Colin Clark ; *The Conditions of Economic Progress* ch. XI

72. P. = b L k Ci .

satisfactory. Nor does an entrepreneur calculate in terms of labour productivity. He counts in terms of the total investment in fixed and working capital, wages of various kinds, rent, depreciation, and all other needs of his business. Production per unit of business capital must, therefore, replace production per head or per man-hour, from the entrepreneur's standpoint, as the measure of efficiency, by relating the input of resources to the output of product. This would give us the following simple formala :

$$E=O/I$$

I=Investment. All the investment of business in the unit under consideration. Thus :

Labour=Payments to all the employees—Wages earners, salaried workers etc.,

Capital=Total capital including both (a) fixed capital in plant, tools, machinery, etc., and (b)working capital including materials, goods in process etc.,

Other payments such as advertisement, rent, interest paid or lost because of comparatively low yielding but necessary reserves and marketing charges.

O= Output i.e., the gross money sale value of the main and subsidiary products of the factory at the rate and of the value as shown in the books of the company.

The working of the formula is illustrated below:

Firm.	Output Unit.	Investment Unit.	Efficiency unit or ratio
A	2	1	2
B	2	2	1
C	2	3	2/3

Thus if A gets an output of textiles valued at 2 lakhs and has invested 1 lakh as contrasted with B with an output of 2 lakhs atd an investment of 2 lakhs, the former is twice as efficient ; and so on. Measuring efficiency in this manner would not only be simple administratively but would induce B either to increase the output or reduce the investment or attempt to improve in both directions.

Efficiency being given, the effective exemption or normal rate can easily be arrived at for each firm. I have suggested that each industry *cum* region should have a standard rate of normal or exempted profits. If, say, it is 8 per cent for cotton textiles, the effective rate would be :—

Firm.	Efficiency Ratio.	Standard rate.	Effective rate.
A	2	8	16 per cent.
B	I	8	8 ,,
C	2/3	8	5⅓ per cent

The deviations of the effective rate would be from the standard rate on the same principle as in the income tax where tax reductions, e. g. family allowances, are made from the standard rate, or additions, e.g., for upper slabs, made to it. The formula for effective rate would thus be:

Effective rate = Standard rate × Efficiency.

$$\text{or E. R.} = S \times \frac{O}{I}$$

The foregoing example exaggerates the differences in rates, for, under normal conditions entrepreneurial ability does not vary in the ratio of 2 : 1 : 2/3 and so also the exempted rate of profits between the firms A, B and C would not differ so widely.

The basic and standard rates may be legislatively fixed. The application of the efficiency formula and of the effective rate may best be and, perhaps should be, reviewed by a Board of Referees. And in the matter of administration such as production, appeals etc., the income tax rules may be followed.

It seems desirable to fix the ceiling and ground rates i.e., the maximum and minimum effective rates. No firm however efficient, should get more than the ceiling level, and no concern which is in the production market should get less than the minimum which might be fixed at the standard rate i.e., a system of top rigidity and upward flexibility may be introduced.

III DETERMINATION OF INVESTED CAPITAL

The Concept of Invested Capital

The basis of the Capital Standard is the quantum of capital involved in the business and on which the normal effective rate of profits is allowed. As the *Economist* put it[73] "Capital employed in the business has been a most complicated question to solve in connection with EPT and the costing of government contracts during the War. But, unlike 1927, we now have an administrative machine which is used to handling these quantities. Despite all the complexities a capital datum can be worked out for every public company, and once this is done, additional capital investment can be fairly readily computed each year" for the assesment of special relief. Some of the main problems connected with the concept are discussed below.

Capital refers to the investment which is actively used in the business. In unlimited concerns the entire property of the entrepreneur is at stake, though only a part of it is used in the undertaking. There is no justification to regard all property as entitled to normal profits, for any concession to the contrary would undermine the operation of the tax and lead to endless evasion. Perhaps the non-recognition of this capital at stake as entitled to the normal rate discriminates in favour of limited concerns but this is inevitable and probably even desirable in the case of medium and large undertakings.

Granting that only capital involved in the business must be included there is still the difficulty of determining what exactly comprises such invesment and this difficulty persists both in theory and in practice. Theoretically, the trouble arises because the concept is dynamic and because the components of invested capital vary in different industries and

73. 26th January 1946, p. 142. The difficulties of measurement mentioned by Colin Clark. (*Conditions of Economic Progress* p. 374) relate to real national capital.

environments. Its dynamic character arises since we consider 'Capital' in its business sense rather than in its academic setting. Whatever the business man pays for and invests in the undertaking is capital. In industry there is nothing like a fixed amount of investment once and for all times. Growth and contraction, replacements and renewals are the breath of business. Capital goods depreciate, deplete and get obsolete but at the same time additions of various types are made and replacements take place. Thus invested capital is a fluctuating and ever changing item, in content as well as in value.

In practice also there has been no consistent inclusive conception, for it is administratively impossible to arrive at any such goal. During the 1914 War both in the United Kingdom and the United States invested capital fundamentally meant "Proprietor's Capital", but there were significant differences also. The chief differences were two: first, the British took a narrower view of what constituted investment in the business, excluding everything in the nature of securities owned by the concern, and bank balances above the amount required for the purposes of the business; and second, they ignored the liability side of the balance sheet and built up their invested capital by dealing entirely in asset items, excluding written-off depreciation or lost assets from the computation. In the United States of America the sum originally invested constituted an irreducible minimum. The British practice of refusing to recognise 'outside' investments as capital invested and to grant wide exemptions from taxation to the purchasers of their war bonds simplified the calculation of invested capital in certain respects and complicated in others.[74]

The problem may be analysed under three heads: (1) what constitutes invested capital, *i.e.*, the various important items that may be included or excluded;

74. Haig, *op. cit.*, p. 81.

(2) since invested capital is dynamic, we must start at some point of time in determining the capital, *i.e.*, the problem of the initial valuation of the investment; (3) the problem of providing for additions and deductions relating to the capital between the initial determination and the subsequent period up to the time of assessing the tax. The last two of these problems are dependent upon the first. The original investment with additions and depreciations as shown by the books of the concern may be accepted as the starting point of the valuation of invested capital. Where such books are not available—such cases are sure to be rare—presumptive valuation may be resorted to.

Constituents

The invested capital of any concern depends largely on three factors—the time and circumstances of its birth, the tone of its financial policy and the character of its book keeping.[75] Obviously, therefore, the inclusion or exclusion of particular items is a matter of detail and must be decided with reference to the particular situation, country, industry and even the individual firm, and this means that the administrative body in charge of the tax should deal with each question as it arises, as was done by the Board of Referees and the Inland Revenue authorities in the United Kingdom. I shall, therefore, confine myself below to the main principles of thc invested capital concept.

Accepting the conclusion that the invested capital on which a return may be allowed should consist largely of the *running capital,* we find three distinct items comprising the later—share amounts of all types, loans of varying kinds and accumulations such as the reserve fund. Little difficulty arises regarding share capital, for it is agreed on all hands that, though the share amount forms generally a small part of the invested capital, its contributors as owners

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75. Compare *Q. J. E.*. 1921, p. 377.

are entitled to the normal return.

The *problem of loans*, however, is complicated. Although loans have so far been excluded from computation of invested capital, there have been differences about the equity of such a treatment both in theory and in practice. During the 1914 War as in the last one, Great Britain excluded it. "Any borrowed money or deposits are deducted as also any unpaid purchase money as assets".[76] But the British authorities themselves had serious doubts regarding the soundness of their own policy. "They are inclined to believe," runs the report on excess profits taxation in Great Britain,[77] "that a more equitable tax would result if borrowed money were included in invested capital and interest on such sums deducted from taxable profits. They have no solution, however, for the problem of drawing a line of distinction between permanent and temporary debt or for taking into account the intangible element of personal credit." Similar was the case in the United States of America and other countries. Under the 1940 American law half of borrowed capital is included. Some writers on excess profits taxation have also been for the exclusion of loans. "The inclusion of borrowed money as invested capital," remarks Montgomery, "would involve very serious difficulties of computation." A similar opinion is held by T. S. Adams. Einaudi, the Italian authority, is, however, for the inclusion of borrowed capital, chiefly on the ground that whether the capital is borrowed or the proprietor's own, the concern as a whole has the same size and the same responsibility, demands the same amount of intelligence and initiative, and perhaps, involves more anxiety and risk to the entrepreneur when part of capital is borrowed.

These doubts regarding the place of loans give rise to two questions: first, whether *in principle* borrowed capital should be excluded; and second,

76. Haig, *op. cit.*, p. 83.
77. *Ibid.*

how in practice such capital can be computed for inclusion. From the first standpoint, there is no ground whatever to discriminate between owner's funds and borrowed money. For profits result from business and it is immaterial whether the invested capital yielding the taxable profits belongs to the entrepreneur or to some other. Not only is it impossible to distinguish accurately between the owner's funds and loans but it is unnecessary. Further if, on grounds of principle, one type of capital is excluded, it would lead to wholesale evasion. Moreover, as the British Shipowners' Parliamentary Committee pointed out, industries and firms which finance themselves by loans or debentures would be hit hard and inequity would result.[78]

This argument would apply with equal force to all types of capital effectively involved in the business, for instance, preferred stock. In the United States of America during the last levy of the tax, borrowed capital was excluded but preferred stock was included in invested capital with the result that corporations showed a tendency to retire bonds by issues of preferred stock in order to get a larger exemption. Apart from such inevitable evasion, there is nothing in principle to distinguish such capital from ordinary loans, from the point of view of the concern and its profits. It may be that certain types of stockholders own the business, take the risk and share the profits and losses in varying degrees, as contrasted with the bondholder or any other type of lender entitled to the interest only. But it is immaterial to the concern bearing the tax, who gets the profit or bears the loss. What really matters is the amount of profits an enterprise is entitled to, such amount being determined with reference to the capital involved in the business. Similar considerations apply to all other types of capital invested, for instance, rented assets.

Two distinct elements of return may be noted in

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78. *The Economist* 8th May 1937, P. 447,

the case of all invested capital—interest and the reward for risk. Even on the shareholder's capital equity demands the allowance of interest in the same way as that paid on borrowed capital. For if, instead of investing his funds in his own business, the entrepreneur had lent them out he would have received interest, and if he had resorted to loans to run his concern he would have had to pay interest. In justice, therefore, all capital actually invested in the business and responsible for the running of it is entitled to interest. Similarly, it is immaterial, from the point of view of risk, how the capital at stake is raised. In case of business failure, all kinds of capital are equally involved, though legally there may be degrees of priority in repayment. When the business succeeds, all capital, however raised, is equally responsible for the profits. So, the entrepreneur should get interest as well as a return for the risk he takes on all capital involved in the business. Thus on his own funds he enjoys interest as well as profits while on borrowed funds also he gets both—only he pays the interest to the lender and keeps the profits to himself. The inclusion of borrowed funds in the calculation of invested capital would encourage the use of venture capital and stimulate employment and production.

The application of this principle leads to the question of estimating borrowed capital. Five distinct kinds of loans may be distinguished—debentures, bank loans, trade loans, borrowings informally made by owners and personal credit. The importance of each of these varies in different types of business and individual enterprises. Very little difficulty arises in the case of debenture since the amount, the period and the rate of interest are definitely known. Loans from banks are also definite to some extent, but short loans, *e.g.*, overdrafts, give rise to complications. For, there is running credit and the amount utilised by an enterprise varies from week to week, if not from day to day. This difficulty, however, can be overcome

by taking the average amount of accommodation resorted to in the course of a year, so that it is not the entire sum that is available at the bank to the business that counts but only the amount actually utilised by the concern which, of course, cannot be accurately measured but must be determined to some extent arbitrarily.

Trade loans, and, to a much larger extent, the other two varieties are more important in the case of partnership and single ownership enterprises. Men with large personal credit do business with stock and equipment advanced by others carrying no interest of the ordinary kind. Often, these advances are so informal that they can hardly be called loans at all. The owner simply sells goods advanced to him on open account turning them over so rapidly that no borrowing of capital in the ordinary sense is necessary. This represents an intermediate stage between the ordinary merchants and the full-fledged broker or commission agent. Similarly elusive are the loans made by owners to their business in the case of unincorporated concerns. In all these cases, three alternative courses of action are available: first, allowing an extra percentage return on the capital which can be determined, in order to make up for the capital which cannot be calculated; secondly, neglecting these elusive items altogether; and thirdly, presumptive capital, *i.e.*, presuming a certain amount as invested capital, according to the varying nature and size of the business, but giving the owner the right of appeal and of providing a larger amount. Each one of these alternatives is somewhat arbitrary and has an element of unfairness. But the last alter native however, appears to be the best and is similar to the procedure followed in income taxation.

Methods of Valuing Invested Capital.—

A few of the many methods of valuing invested capital may be considered below: [79]

79. According to Colin Clark (*Conditions of Economic Progress*, p. 375) there are three entirely separate concepts of the basis on which capital can be

The *Current Apprasial method* has been suggested by T. S. Adams, the American authority,[80] as best suited for excess profits taxation purposes. He believes that the original capital invested in an undertaking has no doubt a real significance in some cases but in the majority of cases should be replaced by some later reproduction value. "Where mature and well organised corporations are concerned that concept has little meaning. The original investment has no permanence. It changes inevitably. Durable assets, such as land and buildings, depreciate and appreciate and these variations may at times be taken upon the books and they will certainly be taken into account in any case of sale or consolidation. Intangible assets are built up and in turn disappear. The true capital, the true investment changes with the shifting level of income and with future prospects based upon such income." He adds[81] "Some corporations are fifty years old or more, and the exact amount of cash or tangible property paid in and the circumstances surrounding such payment, have disappeared in the mists of time. On the other hand, many corporations have gone through formal or genuine reorganisation within the past few years. Some old corporations have written up on their books the appreciation which has taken place in their real estate and property. Other old corporations have not done this. Some corporations have so handled advertising and similar costs that they stand on the books as capital assets, designated goodwill, trade marks and the like. Many other corporations having brands or intangible assets of great value have written off as current expense the advertising and similar expenditure made to develop

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measured, namely, market value, replacement value and cost price, but with the lapse of time those three values are gradually brought together. Clark's further analysis is inapplicable to the present discussion since he deals with the measurment of *real national capital* whereas we (and the entrepreneur) are concerned with *money business capital.*

80. *Annals* Vol. LXXV, P. 152.

81. *Ibid.*, p. 157.

or create these intangible assets. Some corporations have bought goodwill for a very large sum and within the next few years have written it entirely off their books. Other corporations carry the original expenditure as a capital asset. To go back to the original investments in such case is to treat essentially like situations differently."

Adams, therefore, suggests the valuation of capital assets anew as in the period immediately preceding the tax. The entire assets of the business including goodwill must be revalued and regarded as invested capital. Allowance must be made for the inevitable change in the investment. Any writing up or revaluation of assets therefore is to be prohibited, although in computing the earned surplus as part of the invested capital it is necessary theoretically at least to check or otherwise establish the accuracy of the depreciation, depletion and profit and loss account from the beginning.

There is no doubt that these claims about the merits of this method are partly justified. For the method is an important means of fully safeguarding vested property rights. It would protect those who bought the concern in the open market and before the prospect of the tax had brought down the capital value. It would further simpify the process of valuation since all depreciation, depletion, additions, etc., up to the time of valuation would be provided for automatically in accepting the current value of the concern at its invested capital ; and administratively this advantage is very great indeed.

There are, however, outstanding defects in this method. For instance, the current value of a concern depends on its present and prospective earnings and the rate of capitalisation attached to them. There can, therefore, be no independent valuation of invested capital apart from the income which itself is to be taxed. In other words, the value of any investment depends upon its earning. " Logically we can tax earnings objectively without reference to

the value of capital; we must likewise have some objective indication of value, such as, record of sales. But if it is proposed to make a tax on earning depend on the value of invested capital, which itself depends on the amount of earnings, we are involved in circular reasoning. Such a procedure to be logical requires that there be some measures of the value of invested capital independent of the earnings. But there is no such independent measure."

A second drawback of the method is that under such a valuation only windfalls, *i.e.*, profits unforeseen at the time the valuation was made and the tax was levied and, therefore, could not be capitalised, can be taxed. This would mean that the current profits would be always exempt. Perhaps, if the prevailing rate of interest, which is the basis of capitalisation of incomes, is low and if the proposed normal rate of profit is to be, as suggested by me above, a higher percentage than the normal rate of interest, the current profits of even the most prosperous firm would be below normal involving the exemption of even windfalls. In other words, the basis of the tax itself would be tarpedoed. Further, true capital which can justly claim a return is the amount that is really invested in the concern, that is what is necessary to run the enterprise. Otherwise, the current value would be out of joint with true capital and would vary with the amount of income and the rate of capitalisation. Moreover, this method would lead to an infinite variety of discrimination between different concerns and industries, for, current valuation would vary according to their fortunes in the year. Finally, there is no justification for protecting vested interests.

A slight variation of the method discussed above is the *reproduction cost method* whereby the amount of capital is taken at the reproduction value of the concern, which, in other words, is also the basis of current appraisal. The only difference between these two methods lies in the case of non-reproducible

assets, such as, situation and good-will.

An alternative to these methods is the *last transfer method* which claims to avoid the conflict between the preservation of vested property rights and the need for raising revenue with the minimum impairment of incentives to work, save and invest and of ability to bear risks and uncertainties. This consists in taking as our starting point the price paid for the business by the *present* owners, which, of course, includes the amount paid at the formation of the concern *plus* later additions.

There are two chief variants of this last transfer concept. Both include subsequent additions to capital but one, which prevailed in the United States of America at the time of the 1914 War, does not deduct subsequent impairments of capital, and the other, used in the United Kingdom on the same occassion, deducts all impairments. The first approaches from the liabilities side and assumes that capital once put into the concern inevitably stays in for good until it is paid out again to the owners; the other variant approaches from the assets side and assumes that the capital actually available for the business and being used in it is obviously no larger than the value of the assets.

These variants may be passed over here since they affect the question of later additions and deductions.

The *last transfer method* has some important drawback, one being the difficulty of applying it in the case of reorganised firms where the price paid at the last transfer is the capitalised value of the income. Apart from the defects of the current appraisal procedure, this leads to discriminatory treatment between a firm which has been sold at the capitalised value and one not reorganised but continuing under the old owners. Further, there may be stock watering and bogus sale prices and deeds. Transfer may have been effected at different times and circumstances so that the rate of capitalisation and the transfer value would

be different. Finally, this method would lead to an increase in capital value without a corresponding increase in the investment of capital used in the running of the concern. Thus, mere increase in value without reinvestment of earnings or the application of new capital will be recognised giving extra advantage to concerns undergoing transfers.

Yet another alternative is the *capital addition method* which considers only capital invested *after* the tax was introduced. This is based on the idea that that capital already in existence needs no reward—aside from liquid capital chiefly in money form, that could be removed from the taxing jurisdiction. This method disregards invested capital to a large extent and is both unfair and impracticable; it would operate similar to killing the goose that laid the golden egg.

An acceptable basis of valuation is *the cost of investment method* suggested by Fairchild.[82] "The basis should be what the investors have put in the business and retained there. This will be found, I believe, to agree with the best accounting theory and practice. By this method we avoid the whole matter of price changes which makes an almost hopeless tangle of the value basis. We take account only of what the investors have actually put in and taken out and the prices actually prevailing in each instance. We do not have to find the value of past investments at present day prices. This will be somewhat arbitrary and may appear to disregard exact justice between corporations, but any such shortcoming is overwhelmingly offset by administrative certainty and theoretical correctness." In other words, whatever capital has been actually invested or utilised in the business must be taken at the value at which that investment was made. "In fully seventy-five per cent. of the cases no better figures for assets values could be determined by expert appraisal than the

82. *Q.J.E.*, 1920, pp. 789 & ff.

book figures and in at least eighty per cent. of the cases the value of the assets even on the depreciated cost basis is as great as or greater than the book figures." This might hit hard a small minority but appeals in affected cases may mitigate the distress.

Practice all over the world has been on the lines suggested above. For example, in Italy during the 1914 War capital had to be proved by documents, business books properly kept and other clear evidence dated prior to the taxing decree and the capital should have been effectively employed in producing profit, "in France the *capitaux ricellement engages* must be *tel qu its resultent d' acts de livers de commerce regulievement tenus ou d' autres prenves certain.*" Similarly in Canada, where the capital standard was all important the amount paid up on the capital stock was admitted for corporations, while the assets of private firms were valued.

IV TAXABLE PROFITS

Anual vs. Average Profits

An important problem connected with this tax is the determination of taxable profits. As the memorandum on post-war fiscal policy submitted to the Chancellor of the Exchequer in 1944 by recognised bodies of financial accountants of England and Wales suggested, for taxation purposes profits should be measured on sound accounting principles. On this basis Sir John Anderson introduced the depreciation and other concessions in his budget of 1944-45. We might, therefore, accept the *Economist's*[83] generous interpretation of profits. "The real profit of a business is that part of its revenue that is left over after meeting not only all current costs but, in particular, after deducting an amount equivalent to the value of the assets used up in the making of profits." Thus all distributable profits—*whether paid out or not*—become taxable.

83. 29th April 1944, p. 563.

To give effect to this, the accountants referred to above suggested three alternatives, though they favoured the last of them: (1) lower rate of tax on retained profits used for extension; (2) the deferment of tax payments on such retained profits used for extension; (3) a lumpsum allowance to be granted directly expenditure is incurred on major additions, extensions and renewals of fixed assets.

Many other factors also affect the calculation of taxable profits as discussed below. Profits by their very nature are a continuous source of earnings. They might be considered either as arising in the course of the year, *i.e.*, annual gains, or as an average of gains over a longer period. Each of these has its own peculiarity and was followed in different countries. In the United Kingdom, where the excess profits tax procedure during the 1915 levy was fairer than anywhere else, actual profits in the accounting period were considered, although, for purposes of income-taxation, the average income over a series of years was taken into account. "The principle of computing profits," ran the fourth schedule of the Excess Profits Duty Act, "by reference to any other year or an average of years shall not be followed."

This procedure is inequitable and, indeed, appears to have been tacitly recognised as such even in Britain where to mitigate the harshness of this practice a variety of adjustments, such as rebates for years of depression, and exemption of appreciation of asset values, was introduced. Under the E.P.D. of the First World War and the E.P.T. of the Second the U.K. remedied the defect by tacitly accepting the averaging system under which the aggregate amount of E.P.T. payable throughout the whole operation of the tax will be the tax corresponding with the net excess profits over the whole period after allowing for any falling off of profits in any year.[84] With all

84. Sir John Simon's reply in the House of Commons Committee, 4—10—1939.

these adjustments, annual gains are at best passable for a temporary tax and where the purpose is merely raising revenue. For a permanent tax based on grounds of social equity, the annual income concept is indefensible because it introduces discrimination against industries with fluctuating incomes as contrasted with those leading humdrum lives with relatively stable incomes.[85] It is obvious that all enterprises cannot expect the same steadiness of income every year. For instance, in contract work spread over a series of years, the profits might accrue at the termination of the contract. But, meanwhile the contractor might not have enjoyed even a fraction of his profits and might be living on his capital or loans. Similarly in the case of large-scale manufacturing. Further, as is evident from the study of profits, profits vary in amount in different industries in different years. The losses of one year are made good by extra gains in another. In fact, such an expectation of uneven profits is at the basis of dividend equalisation funds. If profits were a steady source both in point of time and of amount, they would lose much of their significance as a reward for enterprise. Therefore, if actual profits accruing in a year are made the basis of taxation, enterprises with fluctuating incomes would be hit hard. "Under the Excess Profits Tax computed on an annual basis," observes J.K. Butters,[86] "corporations with a lower effective rate of earnings over a period of years might very well pay much larger sums than other corporations with higher effective rates on earnings if, in the former case, the profits were concentrated in a fewer years....The more cyclical industries pay a disproportionate amount of the Excess Profits Tax." These conclusions are borne out by the statistical tables he has given. The discriminatory effect of the tax increases proportionately to

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85. J. K. Butters: "Discriminatory effects of the annual computition of the Corporation Income Tax" (*Q.J.E.*, 1939, pp. 50 and ff).

86. *Ibid.* 59.

the increase in the tax rate. This consequence might induce evasion to a much larger extent than it need exist.

After all the purpose of the tax is not so much the exploitation of enterprises which are making excess profits, as the prevention of excess profits and incidently the collection of any revenue. These purposes as well as equity would be served by taking average profits over a series of years. Such averaging would even out fluctuations and afford a fair basis of excess profits. It would reduce the incentive for the tax-payer to evade the tax by shifting the income from one year to another[87] and would act as a powerful equalizing force upon the effective tax rates paid by individual corporations. "The heavy discrimination against the industries more sensitive to the business cycle is in itself a factor worthy of careful consideration.[88] No doubt, averaging would necessarily involve some loss of revenue to the state. The extent of loss depends upon the length of the averaging period and the rate of taxation. But the following statistics relating to the United States [89] are interesting:

Loss of Revenue if carried forward

(Industrial samples: 1929-37-United States of America)

	Two years	Four years
1. All corporations of large sample ...	3·1	6.0
2. Iron and steel ...	6·8	19.1
3. Retail Trade ...	0·9	3·8

87. *Vide* the interesting article by William Vickrey: "Averaging of income for Income-Tax purposes" *(Q.J.E.*, 1939, pp. 378—397). Also T.S. Adams "Should the Excess Profits Tax be repealed" (*Ibid*.. 1921 P. 382).

88. See Butters, *op. cit.*, specially, pp. 69—70.

89. *Ibid.*, Table X. Also see other tables in *Q.J.E.*, 1939, pp. 51—72.

This loss is, however, more apparent than real. For being more equitable, averaging will reduce losses on account of evasion. Further, it might even improve business conditions, thus increasing the profits and the tax revenue. Butters' investigatiof indicates[90] that a two-year averaging would rarely, in ever, result in a loss of appreciably more than 5 per cent. of the revenue over a cycle. "A generous loss carry forward allowance would remove most of the discrimination, with a revenue loss and administrative burden moderate relative to the benefit achieved." Averaging may, thus, be regarded as a *sine qua non* to the fair and successful working of the excess profits tax.

The period of averaging necessarily differs in different industries. A two year average would be too short for any industry, and even a four-year allowance may not be sufficient to eliminate entirely the burden of the tax.[91] T. S. Adams has suggested[92] at least three years in most industries and not less than ten in some. I should regard six or seven years as a fairly long period applicable generally all round though in some exceptional cases the period may be longer. Such an average would necessarily be of the chain type. In the case of new concerns, which have not had an existence of six years or more, the average in the initial years would necessarily be confined to the number of years of their existence. This would mean a great advantage to them, since, if they did not make any profit in the first year, they would not only pay any tax that year but they would get an advantage in the next year as well and perhaps for the next five years in so far as the first year in which they did not earn any profits would go to reduce the average profits of the succeeding years. Under the system of averaging suggested above such prospective averaging is auto-

90. *op. cit.*, p. 66.

91. Butters *op. cit*, p. 71.

92. *Q.J.E.*, 1921, p. 390.

matically provided for, although the period allowed for deduction is limited to six years. The losses which have been incurred in the last six years would be made good by the profits earned in any of these six years and only the excess, if any, would be liable to taxation. It must be admitted that even this procedure has a snag in it, for, in the case of a new concern, suppose profits are made in the first year and a tax is collected but the concern undergoes a loss in the second, averaging would no doubt exempt the firm from the tax in the second year, but should we allow a refund of the payment in the first year if equity demands such a thing ? Generally, under the excess profits tax procedure such refunds may be allowed since cases of that nature would not be many and consequently would not very much upset the finances of the State.

Long-term Contracts

From this point of view it follows that profits of long term contracts should necessarily be spread over the period suggested above and not taxed with reference to the year in which they arise. In the United Kingdom such profits were distributed according to the work completed or expenses incurred, while in the United States of America they were allocated to years with the highest tax rate. Under the 1940 law, specific cases of spread over were allowed. The American procedure is obviously unfair and cannot be made the basis of a permanent tax. The British prodcedure is certainly better. There is, however, the problem of apportioning the profits and the expenses incurred in any particular year. This difficulty also can be avoided if the system of averaging of profits is adopted. A similar question arises in connection with consolidated returns specially where a concern carries on more than one business or owns the stock of another concern. This is especially important in the case of managing agancies. The practice in America and and England has been to consider the consolidated returns, all though the British practice was narrower in so far as a concern to get the benefit of a combined

treatment had to own the whole of the ordinary capital or at least so much as a single shareholder could legally own. While this procedure no doubt gives relief in that losses in one are made good by profits in another, it does not appear to be completely satisfactory. I feel that each concern should be treated independently and the fortunes of each irrespective of the ownership must be taxed at the source. With the averaging suggested above, such a treatment would give all the relief necessary to the concern. An exception would of course be in the case of stockholding concerns.

Investments

Of a similar kind is the income from investments. A good number of enterprises invest their idle capital and sometimes even a part of their otherwise usable capital in the form of income-yielding investments such as buildings and lands. Sometimes this may be to give greater security and confidence to the public in the concern. Examples of this are banks, insurance and sugar concerns which have vast properties in important cities though only a very small portion of such property is directly used for the ordinary business of the concern, the rest being let out as a source of income. Similarly, reserve funds and sometimes even a part of the dividend equilisation fund if accumulated in excessive sums may be so invested. Such investment may also take the shape of purchase of stocks and securities.

Practice is not uniform regarding the treatment of such investments for taxation purposes. In the United States of America incomes from this source were taxed if the recipient was a corporation and not otherwise. In Great Britain such income was not taxable even when it was received by a business concern subject to the profits tax, excepting in the case of life insurance companies and concerns where the principal business consists of the making of investments. The British procedure is the more equitable one, but such non-inclusion might lead

to evasion of the tax by over-investments of the exempted type and also might affect deterimentally enterprise since the safer type of income-yielding investments might be preferred to the more risky and, therefore, more profitable ones. This fear, however, is not of very great importance since enterprise is not generally deterred by such small difficulties and, further, since even this income, though not assessable under the profits tax, is affected by the income and super-taxes. Thus, while following the British procedure we should omit, for purposes of calculating the taxable profits and exempted amounts, both the capital and the income from such investments considering the latter under other kinds of taxes. A question connected with such investment is the provision for variations in capital values of such investments. Variations may be due either to accidental circumstances affecting the capital value itself, *e.g.*, an earthquake or the collapse of a building, or to a fall in the income as a result of dynamic changes or to an alteration in the rate of capitalisation. Such changes may be in both directions, *viz.*, an increase in value or a reduction in it. This problem is rather minor in importance and may be left to the consideration of administrative authorities collecting the tax. Thus, in England the Commissioners of Inland Revenue granted deductions from investment income in cases where, owing to the dimunition in the general purchasing power of money, there was a decline in the market standing of the security from which the incomes were derived.

Salaries

One of the consequences of the profits tax was the swelling of the salaries and other kinds of remuneration of managers and directors, with the definite object of reducing the taxable profits. The danger of evasion by the distribution of profits in the guise of salaries and directors' fees is particularly acute in the case of concerns owned and managed by the same persons, for instance, partnerships and single ownerships. This kind of evasion

would generally disappear under a permanent profits tax, for, no object would be served in permanently increasing the remuneration unless it be as a permanent protest against the tax itself. So long as the tax is not 100 per cent., a concern, by raising remunerations artificially, would not only deprive the government of its revenue but would hurt itself to the extent of the difference between the rate of the tax and the amount of increase, thus cutting off its own nose to spite the face. Under a permanent tax, therefore, we need not fear this kind of evasion. Assuming, however, that evasion is possible, we might adopt as a counter measure some of the remedies followed during the last levy of the tax. For instance, in America, increases made after, or even recently before, the levy were closely scrutinised. In England increases without the permission of the Inland Revenue were disallowed and only pre-tax, *i.e.*, pre-war level of salaries were permitted. New firms were treated as partnerships and a higher statutory rate of normal profits was allowed to make up the remuneration. All increases were to be recovered by the firms from those who received the salary so that taxable profits were not affected. In practice increases up to a certain sum were generally left unchallenged. Under the 1939 tax, companies were not allowed to charge a greater sum for directors' fees than that which was payable in standard years, though exception was made for directors who were acting as whole-time managers and who controlled not more than 5 per cent. of the share capital of the company.[93] In Canada the maximum allowable per proprietor was fixed.[94]

Taxes already paid

Another question is the *provision for other taxes* paid already. This is specially important in the case of income tax. (It is not envisaged here that *either* the income-tax or the excess profits tax should be paid and not both.)

93. *The Economist*, 7th October 1939, P. 16.

94 *The Canadian Excess Profits Tax Act*, 1940. 6, 2b.

On the other hand, I feel that a firm should be liable to both the taxes since their bases are different and they are really two distinct taxes. The excess profits tax is essentially a levy on a particular abnormality in the gains, while the income tax is a general tax applicable to all receivers of income even though such income is not excessive. Thus, a concern cannot escape paying the income tax merely because the excess profits tax is also collected, in the same way as a person is liable to tbe ordinary income tax as well as the super-tax and cannot escape the former by paying the latter. Granting the equity of this point of view, how should the two taxes be collected? It is sometimes feared that the two taxes together may take away more than the total net income, but such a fear is absolutely unfounded, for the simple reason that the taxes are levied not simultaneously on the same quatnum of income but successively on the income that remains after the payment of the other tax. There are four possibilites in applying both the taxes to a concern. I. The deduction of the excess profits tax in the first instance, and then applying the income tax at the rate fixed on the balance of income consisting of the exempted normal rate of profits and the balance of excess profits after the payment of the profits tax. This method, which is the most equitable, was applied in Great Britain and Canada during the 1915 and 1939 levies of the tax and in the United States of America from 1917 to 1920 and since 1941 and has been known as the tax credit method. II. The deduction of the incometax on all the profits—normal and abnormal—and then applying the profits tax on the excess profits, e.g., in vogue till 1941 in the United States of America. Either of these methods may be adopted. Which of them is better depends upon the rates of the two taxes. If the rate of the profits tax is higher, then the state would lean towards the first alternative since it would get a larger revenue and if the incometax is at a higher rate it would prefer the latter. From the point

of view of the tax-payer, the opposite procedure would be better since his burden would be less. But as the profits tax generally tends to be higher and has also an ethical object in view, I regard the former procedure as both equitable and profitable. III. Deduction of the excess profits tax due from the income-tax collected. IV Deduction of the amount due under the incometax from the profits tax revenue collected. These alternatives really involve the levy of one of the taxes and not both and as pointed out above both the taxes and not one only must be levied.

Double Taxation

To the same class belongs the *problem of double taxation* between two countries. Should profits earned in a foreign country and which have already paid the tax in that country be again liable to the profits tax ? It has already been suggested that in equity the tax should not be levied over again except to the extent of the difference in rates, so that that portion of the profits which has already paid the tax should be given an off-set to the extent paid. The solution to the problem also involves the broader questions of whether investments in foreign countries should be encouraged and whether a double taxation relief agreement exists between the two countries concerned. Such relief agreements are essentially a matter of growth and of understanding between two countries. As late as 1937 the Financial Secretary to the British Treasury said [95] "There is noreason for us to believe that foreign countries would accept the system of double taxation relief which applies within the British Commonwealth, even if we are prepared to extend it to them." It was only in 1945 after the catastrophe of the Second World War and the growth of understanding that a very desirable agreement was entered into between the United Kingdom and the United States for the avoidance of double taxation and the prevention of evasion.[96] And

95. Quoted in *The Economist*, 5th May 1945 p 601

96. Similar treaties exist between U.S.A & France, S. Africa & Canada France, Belgium and Holland, etc.

it might serve as a guide to other countries.

The agreement is a compromise between the residence and origin principles, and a little of both is followed. Non-residents are exempted from some taxes, while other taxes are reduced in their favour, and for the remainder they get a credit against their home tax liability. Thus the treaty abolishes double taxation, making total tax payable that which is appropriate to the recipient under the laws of the country of residence. This is done, in most cases, either by crediting tax payments in the country of origin of the income against tax due in the country of receipt, or by complete reciprocal exemption from tax. The treaty covers income receipts of every sort.

Losses and Set-offs

The problem of *set-off* leads to the question of the provision for *losses*. Should bad debts, inventory losses and pre-tax losses be allowed to be deducted from taxable profits ? Practice differs in different countries and the fairest of them seems to be the British one which permitted the deduction of current profits to restore pre-war losses and the writing off of bad debts by periodical evaluation of capital. Inventory losses were provided for by the use of the base stock method. In Canada revenue losses of preceding years were deductible from current profits. While this is certainly fair and just, the problem of provision for losses is unimportant and is largely provided for by the system of averaging profits suggested above. Where, however, specific cases arise they can be dealt with on their merits by the administrative authority.

The same remarks apply to set-off for bad years. It is obvious that because business is a continuing operation and must show profits over the entire period of its existence, the losses of bad years must be made good by the profits of the the good ones. In this respect the American practice where the "annual gain" concept held good and adjustments for previous year's losses were not allowed is deplorable, since the

State followed the policy of "Heads I win, tails you lose". Nor much more satisfactory was the American 1940 procedure whereby only *specific classes* of profits earned over a series of year but realised in any one year are allowed to be spread over, while long-term capital gains and losses were disregarded. The British procedure may be adopted. It considered the excess profits over the entire period of operations subsequent to the imposition of the tax. The British went a step further and allowed losses and abnormally low earnings during years preceding the imposition of the tax. Taxes collected were sometimes restored to set-off losses, special reliefs were given and appeals allowed. The losses in one business were allowed to set off gains in another if both were run by the same concern. These principles are no doubt equitable, but they would become unecessary if the average profits over a long enough period are regarded as the taxable basis. There must, however, be a time limit to the losses that could be made good by future profits. Merely because business is a continuing operation, the losses sustained long ago cannot and should not be set off against gains made years or decades later. A stretch back of 6 years would, I believe, be a sufficiently long and fair period which, however, may be extended in the case of special businesses or under special circumstances, such as during a depression. It is, however, doubtful if the British practice is sound with reference to the set-off of losses of one business against gains in another unless the two businesses are really parts of each other. Otherwise, there will be no limit to the number of businesses that could not nominally be undertaken by one and the same managing agents.

Depreciation

Provision for *depreciation* is another important problem though it is not peculiar to the excess profits tax. Some of the difficulties met with during the last levy of the tax were largely traceable to the temporary nature of the tax which naturally demanded more provision

for depreciation and led to other methods of evasion. If the tax was permanent, evasion with the hope of making good the reduction in profits by providing for future depreciation also during the period of levy of the tax would not hold good. But provision for depreciation is both necessary and usual in business, To avoid the danger of allowing the total amount to be charged during any one year it is necessary to arrive at some definite principles with regard to such charges. Three alternatives are possible: the fixing of maximum rates, of agreed rates and the adoption of the arbitration principle wherever dispute arises. The first of these can easily hold good in the case of ordinary depreciation, for example, wear and tear and renewal of machinery. Where a dispute arises the administrative authority, the Board of Referees, might be appealed to regarding the amount, time of charging and items of depreciation allowed. Exceptional depreciation cannot, however, be provided for by the fixation of maximum rates. Such depreciation is peculiar to certain types of businesses where capital loses its value very rapidly and where machinery becomes obsolete very quickly, *e.g.*, buses. This would necessarily mean the allowance of different rates for different businesses, rates which may vary as in England from 3 per cent. in the case of cables to 20 per cent. in the case of buses. Consequently, and also because it is a matter of detail, the problem of exceptional depreciation must be tackled as it arises by the administrative authorities. Ordinary depreciation rates can be standardised through agreements between the revenue authorities and the trade itself, whereas in the case of exceptional depreciation great elasticity is both necessary and could be introduced by the adoption of the agreed rates principle or the arbitration principle. Exceptional depreciation should apply to all the assets employed in the trade or business.

A great deal of the depreciation etc. provisions in the British Income Tax Act of 1944 may be adopted

with necessarymodifications. Thus an initial allowance of 10 per cent of cost of new buildings, with an annual allowance of 2%, an initial allowanee of 20 per cent on capital expenditure on plant and machinary on the replacement cost; of a similar allowance of 10 per cent on works in extractive industries with annual and balancing allowances; an allowance on the basis of 10 year forward spread on capital expenditure in agriculture; an annual allowance on purchase of patent rights and spread over 17 years, allowance for scientific research and exceptional depreciation etc. The actual reasonable rate for any industry would be at the discretion of the commissioners.

Two main facts must be borne in mind. First adequate provision for research, and, perhaps, all genuine expenditure on industrial research in all its stages from the laboratory to full scale production may even be exempted from taxation, since it helps the tax-paying industry, the tax-gathering state and the community in the long run; secondly, in view of rapid technical changes in machinery and methods of production, allownces for replacement must be permitted even though the existing plant is not beyond repair. Sometimes new and better tools to carry out a given process may be adopted and sometimes the process itself may be superseded by a new and better one requiring different equipment altogether.[97] Such technical progress cannot be predicted and so the rate of allowance for this factor is not calculable. The British, therefore, adopted in 1944 the device of a uniform initial allowance described above. While this is administratively convenient, it appears better to have that allowance periodically adjusted and varied from industry to industry, since conditions vary between industries and between different times. Flexibility can be introduced by fixing a basic allowance and allowing appeals to the Board of Referees.

Similar to depreciation is the problem of *depletion*,

97. *Infra* ch. V.

Depletion

Depletion is associated with a very limited number of enterprises such as mines, and results in wasting assets and reduction in the capital value. Strictly, it should be provided for in the determination of capital but provision could be made in the taxable profits of the businesses. A sliding scale of gradual increase in taxable profits as the assets are wasted would provide for such cases. But it is impossible to know the length of life of a mine so that the decrease in capital value cannot be provided for in the profits similar to the provision for depreciation, In the United Kingdom, for instance, no legal provision was made for depletion but the Board of Referees provided for it under the headings of cases of hardship though the ordinary normal percentage of allowance had provided slightly for the element of wasting assets. The Board granted certain classes of mines, increases in normal percentage varying from 2 to 21½ per cent. as against other concerns which were allowed on similar grounds of hardship upto 9 per cent. Two solutions present themselves: (1) the allowance of a higher normal percentage in cases where depletion is present. This, however, is not adequate since, as already stated, the extent of depletion cannot be anticipated; (2) the determination of the allowance in each case as it arises and on the merits of it by the administrative authorities. This appears to be more equitable and practicable.

The questions of *amortisation* and postponed repairs are not important in a permanent tax.

Capital Gains

A really ticklish problem is that of *capital gains*. Variations in asset values are in the natural course of business, and may be either in the nature of increase or decrease in capital value. Such variations become important on transfers of the assets by one part to another. Increases are sometimes in the nature of income to the owner. Such an increase may be due to various factors: It may result

from current expenditure of profits on building up the capital. This of course is not directly a gain in so far as profits have been diverted to capital formation but indirectly it would reduce the available taxable excess, for it would increase the exempted amount of profits and mean also a larger depreciation provision. Such cases of increase arising from reinvestment of profits would not generally be important in the case of permanent tax since there is limit to the reinvestment of profits and the size of a concern. Capital gains may also be due to speculation where the hope of higher prices or profits or the absence of alternative sources of investment may lead to increased capital values; or, again, value may increase due to the prospect of getting increasing income or to the greater earning power of the concern. In either of the above cases the levy of a permanent tax would considerably prevent increases in so far as the reduction in the rate of profits would reduce their income and, therefore, the capital increase. But there will stiil be a certain element of capital gains. A businessman might sell the appreciated assets in bulk or as part of a going concern without subjecting the resulting profits to the tax. In such cases it seems reasonable to regard increases—whether they are due to reinvestment of profit or speculative causes—as taxable profits. In order to escape such a procedure business might be exchanged in kind, *i.e.*, one concern for another. This, however, would not affect profits since the amount of profits would not increase merely as a result of this transfer. As in the American Revenue Act of 1934, a graduated rate of taxation on gains according to the time factor may be adopted. Wherever, however, such cases arise —they cannot be many—the administrative authority might decide the case.

Prices and Profits

Another important problem is the relationship between prices and profits. Any fluctuation in prices is bound to affect profits and taxes. A fall in prices would reduce profits and automatically the burden of the tax. A

rise, however, may have different repurcussions according to the circumstances underlying it. Firstly, higher prices may result from increased cost of production such as a check to the supply of a factor, state fixation of higher minimum wages, etc., but this does not necessarily mean higher profits, and consequently, no new problem of taxation of profits would arise. Secondly, prices may rise on account of increased demand without a corresponding augmentation of supplies. Whether this is a short period tendency, or a long period phenomenon, profits will increase; so also when production changes from competitive to monopoly conditions, *e.g.*, by amalgamation of firms. In these cases the higher gains are automatically affected by the excess profits tax, as the excess now is large.

A problem, however, crops up when prices and, therefore, profits increase consequent on *inflation.* As Hicks puts it[98] "Inflationary profits, although they may be high in terms of money, and, therefore, liable to the Excess Profits Tax, may not be at all high in real terms because their real value is cut down by high prices. , . . Profits rise, not in proportion to the rise in prices, but more than in proportion because they are calculated as a difference between selling prices (measured at one level of prices) and cost (measured at a lower level)." Hicks points out two difficulties from the tax-payer's standpoint : (1) profits rise more than in proportion to prices ; (2) the higher profits are not real but largely nominal. Both difficulties can be easily avoided.

Inflation is essentially temporary and rarely as catastrophic as the hyper-inflation in Germany after the 1914 War. It must be remembered that high prices are not always due to the shifting quantity of money. As at presant in India, there may be an increased demand for goods consequent on population increase,

98. *Taxation of War Wealth*, p. 56

or the greater spending power of certain sections as in the case of the American and British armies in India to-day because of greater wealth, reduced supply, etc. However, assuming that monetary causes alone are responsible, high prices affect both profits and cost. Cost would increase partly due to state action and perhaps partly to economic factors, e.g., higher wages, and higher prices of raw materials. There would, of course, be a time lag between rising prices and rising costs just as there would be one in the falling period—costs rising and also falling later than prices and perhaps not proportionately, so that profits would rise earlier and to a greater extent than costs but would fall also earlier and to a greater extent as a result of monetary variations. This tendency would reduce the advantage or make up the disadvantage which high or low prices mean to the producer, as profits and losses would be ironed out if averged over the period of rising and falling prices. Thus, the first of Hicks's difficulties would be met by the device of averaging profits over a period of six years as suggested by me already.[99]

There, however, remains the second problem that money profits, high or low, would be different from real profits. The obvious solution is the application of a price scale to the normal profit level. Three alternatives are possible: (1) the normal profits allowed to any industry might be linked to the general price index, especially during the inflationary period so that the producer will still be getting normal real profits at the same rate as in the pre-inflationary period. Thus, for example if the normal rate was 10 per cent. and if prices rose to 250, the exempted level of profits would automatically increase to 25 per cent. The state would tax the excess and would itself be affected in its revenue by inflation while the producer would not be affected so far as his basic return goes. (2) Instead of the normal rate, the total profits might

99. *Supra* pp. 186 and ff.

be linked to the price level and be purged of inflationary effect and reduced to the normal price level. The old rates of exemption and taxation could now be applied to the reduced profits as usual. This method, however, is not very commendable because it is not only more complicated but would involve loss to the state. (3) The capital value of the concern might be tagged on to the general price index and the percentage of exemption might be allowed on the new capital value. Thus, if the pre-inflationary value of capital invested in fixed and working assets was 10 lakhs and there was a rise of 150 points in prices, capital would now be valued 150 per cent. more, *i.e.*, 25 lakhs and the old rate of normal profits may be allowed on the new valuation of capital.

The last of these is applicable only to the capital standard type of tax while the others would hold good in all three cases. I should prefer the first solution to the others as it is more simple of operation and equitable in effect.

These and many other minor problems are bound to arise and they may be tackled as in the American Act of 1940 by the use of definitions already established by practice and ruling, the use of basic data already on record, the treatment of intangible property like tangible property, etc., and, more than all, by giving the administrative authorities unfettered discretion.

CHAPTER V.

The Effects of the Tax

IMPORTANCE OF EFFECTS

The purpose of taxation as of all economic activity is the maximisation of social welfare. Some taxes may be levied with the revenue motive and others with the restrictive or deviatory objects but their ultimate aim is directed towards the increase of social advantage. Consequently, a tax system as well as any individual tax stands or falls as judged by its effects upon society. In fact, a study of the *total* economic effects of fiscal policy would be very much more fruitful than mathematical speculation as to the burden of a particular tax. For that matter even the consideration of the incidence of a tax is merely a step towards appraising its effects.

In applying this test it will naturally be difficult to follow accurately all the repurcussions and consequences that may be associated with any tax. To start with, the long range effects of taxation largely hinge upon the uses made by the state of the tax revenue and it is not always easy to trace up the specific consequences of state expenditure. Equally difficult would be the study of the incidence of its burden, for there may be diffusion of the tax among the various elements of society which are also affected by many other factors very different from the tax. The course of economic activity may change during the period when the tax is levied, but this change may be the result of a multiplicity of causes, each one of them not accurately distinguishable either in its course or in the magnitude of its influence. Again, a tax may be pyramided so that its final burden may be much heavier than the tax itself. While, therefore, it would be exceedingly difficult to estimate accurately the real burden or benefit of a tax or even to follow the course

of its shifting and incidence, the changes that have been brought about or that might be expected by its levy should be the touch-stone of the desirability of the tax although the tax might violate some of the orthodox principles of taxation and involve unknown and unforeseen administrative problems.

Such effects by which a tax is judged need not necessarily be financial or even economic. They may be indeed harmful economically. The sum total of the effects–we might call them ulterior consequences if we so like–on society should be the only guide as to the desirability of a tax. I do not, however, propose to analyse below all aspects of the effects of the excess profits tax ; but I shall confine myself to the economic side only under three heads : prices, production and planning,

EXCESS PROFITS TAX AND PRICES

The prevalent view

It has been held in certain quarters that the tax affects prices by being shifted from the producer to the consumer. The association of this tax with prices is indeed decades old. The opponents of the Georgian excess profits tax urged in December 1863 that the tax operates wholly upon those who are consumers, for, in order to meet the burden of the tax imposed, producers and traders will, of necessity, advance the prices of their productions and speculations, which advance must be paid by consumers exclusively.[1] " Its burden like that of indirect taxation ", observed a critic more than fifty years later[2] ; " is distributed by means of prices throughout the whole body of consumers." The New York Chamber of commerce contended[3] that the effects of the excess profits tax on the high cost of living was so evident as to require little explanation. According to David Friday,[4] the

1. Protest lodged in the Georgian Legislature ; *House Journal* ; 1863 p. 274 (*J.P.E.* 1910, p. 625).
2. *The Economist*, 20th September 1919 p. 471.
3. *The Annals*, 1920, P. 168.
4, *Ibid.*

great mass of the American public believed that the tax had been largely responsible for the high level of prices that prevailed during the 1914 War and immediately after. The representative of the London Chamber of Commerce observed in his evidence before the Colwyn Committe [5] that a trader fixes his prices by adding on to his cost "a margin of profit for himself, and of course it is his profit that is subject to the direct income tax, and if he wants to get a sufficient reward for his own exertions, he must put on an addition to his price sufficient to cover the profit to the Government as well as the profit to himself." An American economist put this viewpoint as follows: [6] "Our conclusion must be, therefore, that, while the tax is often a very real burden on the seller or manufacturer, it also raises prices to the consumers who, furthermore, suffer from being obliged to get along with less or poorer supplies." He added that the fact fewer businesses failed during the taxed period than in the pre-tax years can hardly be explained on any other ground than that the heavy taxes, together with the ordinary wasteful costs have both been absorbed by rising prices. In asking for its repeal in December 1919 the Secretary of the United States Treasury contended that [7] in many instances the tax acts as a consumption tax, is added to the cost of production, upon which profits are figured in determining prices and has been and will, so long as it is continued on the statue books, continue to be material factor in the increased cost of living.

We might, therefore, investigate whether this view is really sound theoretically and whether the

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5. *Report*, para 294: Also see Seligman: *Studies in Public Finance*, pp. 73 and ff. For the businessman's theory of taxation & prices, *ibid* p. 296

6. *A. E. R*, 1920—Also see Plehn's review of Montgomery's *Excess Profits Tax Procedure*, *Ibid* P. 375

7. *Ibid* p. 298 Very recently Buehler in his *Public Finance* p. 542 characterised the tax as a dead weight upon business, curbing initiative and causing higher prices.

tax was actually the cause of high prices during the period of its levy. The effect of any tax on prices manifests itself either directly or indirectly. The indirect effect consists in limiting the output which would naturally upset the equilibrium in the market and thus result in higher prices. It is also possible that saving and investment as well as enterprise may be affected, resulting in the withdrawl of factors. Another aspect of indirect influence consists in the negative effects of the tax. Thus, improvements in production leading to lower prices may not be adopted, or the reduction in cost and, consequently, in the price may not be effected or the old price may be maintained though the cost of production is lower, the difference between the old and the new costs being made up by a part or the whole of the tax. All these indirect results may be considered under the succeeding sections dealing with the long term effects of the tax on society. I shall discuss below only the direct effect of the excess profits tax on prices analysing the theory of prices and that of shifting, verifying these theoretical conclusions with the experience of countries during the last levy of the tax.

The effect of taxes of prices :

The direct effect is a matter of shifting which is largely a price process resulting in incidence. Consideration of incidence necessarily involves, as Grenville Holden observes,[8] consideration of the effects of public expenditure and other variables upon both demand and supply functions, the demand function for various goods and services being simply the supply function of other goods and services. Thus, if the revenue from the tax is spent in such a way as to affect demand for or the supply of the taxed goods, it has its influence upon incidence. Further, if the general economic area within which price is determined and the specific economic area of the administration levying the tax and spending its

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8. Incidence of taxation as an analytical concept. (*A.E.R.* 1940, p. 775)

proceeds do not coincide, this is bound to have repercussions on the incidence of the tax.

It is, therefore, difficult to gauge accurately the extent and direction of any tax burden which are more to be deduced than ascertained. A great deal, however, can be inferred by analysing and synthesising relationships under observed conditions.

How then are prices determined according to economic theory and in practice? In a perfectly competitive market, which does not exist in practice anywhere, normal value is determined in a large measure by the interaction of marginal demand and supply prices. According to the Marshallian analysis the price determining supply price is the marginal cost of production associated with the marginal producer whose expenses are the highest but whose services are necessary in order to satisfy the demand for output. It is also just equal to the marginal demand price and, therefore, to the price that can be expected to prevail normally in the market. Thus, there is no element of profit in the marginal supply price. According to the dynamic theorists of the Hicksian school also, the same conclusion is inevitable, although the approach to price determination is different. From the side of supply, price is determined where marginal revenue equals marginal cost. Marginal cost, however, is that of the marginal unit of output and not of a seperate and distinct marginal producer. There may be differences in the efficiency of the competing producers as marginal and intramarginal producers but each of them including the most efficient firm has his marginal output and his marginal cost. This would mean that, while no distinction between producers as marginal and intramarginal is either important or perhaps even valid, the significance of marginal cost as affecting the total output in the market and in price determination still holds true. While the average costs might differ as among competing enterpreneurs, marginal cost and

The Theory of Prices

marginal revenue do not, since they relate to the marginal unit. This cost, again, is equal to the marginal revenue which means that the price in the market just covers the cost of the final unit and that there is no element of excess in the price which prevails in the market. Thus, according to both these schools, it is clear that the price determining cost has no element of profit. On the other hand, in the short run there are often a number of extramarginal firms whose average cost is higher than the prevalent price for "under pure competition marginal revenue is equal to a price which is determined by the short run equilibrium of demand and supply for the *industry*."[9]

The latest in field of price theory is the "full cost" principle,[10] which is based upon practical investigation into the way in which businessmen decide what price to charge for their products and what output to produce. "It casts doubt on the general applicability of the conventional analysis of price and output policy in terms of marginal cost and marginal revenue, and suggests a mode of entrepreneurial behaviour which current economic doctrine tends to ignore."[11] It is offered as an alternative to the Hicksian economic analysis which regards behaviour that is of small practical importance as typical and what is a well marked mode as unusual. Generally producers do not aim in their pricing policy at the maximisation of profits by equating marginal revenue with marginal cost, some because they think of long term profits and others because they apply a rule of thumb which may be called full cost; and "maximum profits if they result at all from the application of this rule do so as an accidental or possibly evolutionary bye-product". An overwhelm-

9. Tax shifting in the short run; by E. D. Fagan and R. W. Jastram (*Q.J.E* 1939, p.563)

10. Price theory and business behaviour by R. L, Hall and C. J. Hitch (*Oxford Economic Papers*, May 1939); also Price and cost in entrepreneurial policy by R.F. Harrod.(*ibid*). I have tried to put this theory as nearly as possible in the words of its orginators.

11. Hall and Hitch. *op. cit.* P.12

ing majority of the entrepreneurs felt that a price based on full average cost including a conventional allowance of profits was the right price. This meant either a price equal to costs or some traditional or convenient price acceptable to consumers, though in exceptional periods this price varies. A common procedure was the setting of a price by a strong firm at its own full cost level and acceptance of this price by others. The general formula of computing full costs is as below :[12] "Prime or direct cost per unit is taken as a base, a precentage addition is made to cover overhead or on-cost or indirect cost, and a further conventional addition, frequently 10 per cent, is made for profit. Selling costs commonly and interest on capital rarely are included in overheads ; when not so included they are allowed for in the addition for profits." About 80 per cent of the firms investigated into adhered to this principle. It is interesting to note that the ruling price approximated to the full cost of the represetative firm rather than of the optimum or the marginal firm.

Hall and Hitch further point out that monopolistic competition with an usually large admixture of oligopoly is more common in the market, and the actual price is determined between the limits set by the polipoly price and the price which would be established if the industry as a whole acted as a monopolist, on the full cost principle conditioned by such historical accidents as the size and efficiency of the firms in the industry, and the extent of their optimism and fear of potential competitors. This is a long period tendency but it holds good even in the short run.

Under this analysis also there is no excess element of profit in the full cost determining the price.

Under conditions of monopoly it is well-known that prices are determined by the monopolist at the

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12. *Ibid* P, 19.

point of maximum monopoly revenue, which is higher than cost.

The Theory of Shifting

Shifting, which gives rise to incidence, may be backward, sideward or forward. Backward shifting consists in passing back the burden to the producers of the raw material or to the other requisites of production. This is possible largely in the case of factors with inelastic supply and in some cases of joint demand. Sideward shifting consists in capitalisation of a tax by a fall in the value of the investment. Obviously such a course is possible where the tax is on the yield from a source with a capital value.

In forward shifting, which is really the most important type, the assessee passes on the burden to the consumer. Only some but not all taxes are capable of being transferred by the assessee in the form of increased prices. It is well-known that most indirect taxes are shifted but only very few of the direct taxes; for, if a tax is laid at a point remotely and indirectly connected with a price determining factor, that tax is difficult to shift, while a tax connected directly with the factor can easily be shifted. "The degree in which a tax may change the price of a commodity is not only the function of the elasticity of demand and supply but is also a function of the proportion which the quantity of a commodity produced or sold within a market area in which the price is determined. It follows that some taxes cannot be shifted if levied by a local unit but may be, if levied by a national government, and that some taxes cannot be shifted at all."[13]

As a general rule, if a tax forms part of cost of production, it must sooner or later be recouped in the price of the product; but if it is not a cost, it cannot affect the output and the price. Profits represent not

13. The incidence and effects of taxation : some theoretical aspects, by M. Slade Kendrick. (*A.E.R.* 1937, P.729)

cost but surplus over cost. They are a consequence and not a cause of price. A tax on profits cannot reach the marginal no-profit unit. As A.C. Pigou has pointed out,[14] if people are already charging the prices that yield them the best profit, the removal by the state of a portion of the profits will not tempt them to fix prices differently. If it was possible to fix profits at will by increasing prices because of anticipated increased taxes, profit-making would become very easy indeed. Thus a tax on net returns will not reduce output and, therefore, cannot alter price.

Writing of the incidence of the tax on income–of which profits are a species–the Colwyn Committee observed[15] that the income tax will not, except very occasionally, affect the cost of production ; it will not affect the price the public are willing to pay for the goods unless, indeed, it makes them more careful purchasers, that is to say, it will not disturb either of the elements on which profit depends. Later they concluded,[16] " These statistical results represent a basis of solid fact and afford strong confirmation of the view derived from processes of reasoning that price is determined by considerations into which the income tax does not directly enter. There is no sign of traders demanding a price to cover the income tax as a condition of their carrying on their business. On the contrary, . . . in a free competitive market with ample supplies in relation to demand, price at any time is measured by the cost of production to the marginal producer. That price yields no profit and is not liable to income tax ; no element of tax can enter into it." Thus, even a normal income tax cannot ordinarily be shifted.[17]

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14. Evidence before the Colwyn Committee, quoted in the *Colwyn Report* para. 296. 15. *Report* para 303. 16. *Ibid.* Para 308.

17. For a detailed analysis vide D. Black : *Incidence of Income Taxes* where he distinguishes the incidence of partial and general income taxes in stationary and progressive communities, and under conditions of monopoly and competition In some respects his conclusions differ from those of the *Colwyn Report* quoted above.

While, therefore, a tax on profits cannot ordinarily be shifted, there are a few cases where such shifting is possible. Firstly, a tax on a *particular class* of profits, like the particular income tax, can easily and will usually be passed on, in so far as factors will be moved to avenues of production where profits are not taxed; consequently, the output will be reduced and the prices increased. Secondly, an element of "profits"–not in the strict economic sense of "pure profits"–forms, as Hall and Hitch have pointed out,[18] a part of the full cost which even the marginal producer must realise in the long run and is, therefore, a monetary reward necessary to secure the services of the agent required for the production of the output. If the tax infringes on this "normal profits" and, thus, on cost, output will be reduced and short run prices increased. The extent of the increase in prices and of the decrease in output will necessarily depend upon the extent to which the tax infringes on profits and upon the elasticity of demand. There would, however, be a shifting of the burden, and this conclusion holds good under pure as well as monopolistic competition. The third exception depends on the nature of the levy. A proportional profits tax will not affect either market or short-run price. But where there are alternative markets and the tax is progressive, a change in the volume of sales and price may be expected if the rate is sufficiently steep.[19]

These exceptional cases do not, however, affect the general conclusion that normally a tax on profits would not be added on to price. This holds true particularly and *without an exception* in the case of the excess profits tax, provided the normal profit allowed is reasonably high.

There is, however, a possibility of the tax entering into price where the producer or trader would make its imposition *an excuse* for charging a higher

18. *Supra* page 212

19. Tax shifting in the market period; E. D. Fagan. (*A.E.R.* 1942)

price and the conditions in the market enable him to hold to that price. This, at best, is temporary and can hold good in remote places where competition is small and the trader holds the position of a monopolist. But even there, as Seligman points out,[20] the tax is really an excuse for, rather than a cause of, higher prices. Otherwise, there is no theoretical possibility of the tax being shifted on in the shape of increased prices.

This conclusion holds true whether production is competitive or not. Under monopoly the price of the article will always be fixed at the highest point consistent with the greatest sale. This is the point of maximum monopoly revenue. If a monopolist were to raise the price beyond that point, his sales would fall off and so also his revenue. Unless the tax is imposed on the output or the gross profits, prices cannot be increased, since under a net profits tax the point of maximum monopoly revenue will remain as before.

The Test of Experience

This theoretical conclusion of the extreme improbability of the excess profits tax entering price might be verified with reference to the experience of price variation during the last two levies of the tax. The following table indicates the course of prices in the United Kingdom and other countries.

20. *Studies in Public Finance*. p. 76.

PRICE MOVEMENTS: 1913-1925 AND 1939-1946

	United Kingdom	India	Canada	United States of America
	Statist	Calcutta	Dominion Bureau of Statistics	
1913 (Base)	**100**	**100**	**100**	**100**
1914	100	104	102	97
1915	127	100	110	107
1916	160	112	131	128
1917	206	122	178	170
1918	226	140	199	203
1919	242	180	209	203
1920	295	230	243	204
1921	182	....	171	123
1922	154	....	152	122
1923	151	....	153	146
1924	164	....	155	139
1925	159	....	160	161
1939 (Base)	**100**	**100**	**100**	**100**
1940	140	121	113	104
1941	157	141	123	117
1942	164	158	130	120
1943	167	228	136	135
1944	171	241	140	136
1945	174	244	141	138

The case of Great Britain

It may be observed that prices in the United Kingdom increased by 166 points between 1914 and 1920 when they reached the peak. In the pre-war years prices were comparatively steady and the rise began as soon as the war was declared. The excess profits duty was introduced in December 1915. By that time prices had not only shown a tendency to rise rapidly but had actually gone up by more than 20 points. Prices began to rise even before the tax was introduced. In 1915 the rate of the tax was 50%. Price, however, increased almost steadily and at the same rate during all these years. The steadiness of the rate of the tax in 1917-18 did not arrest the increase in prices. On the other hand, when the tax was reduced to 40% in the next year, prices continued to shoot up without showing any response to the tax variation. Similarly, prices began to fall in 1920 and by 1921 had gone down in a single year by a hundred points although the tax was maintained at the enhanced rate of 60 per cent. When the tax was finally abolished in 1921 prices did not show any tendency to come back to their pre-1914 level. In other words, there does not appear to be much correlation between the price movements and the tax changes indicating that the two are largely independent factors. British businessmen naturally claimed that the tax led them to increase prices, but R. M. Haig, the American economist who investigested into the question, concluded that[21] this view was "at once an apology for past greed and a plea for future exemption from just taxation."

It may also be noted that, during the period of the tax, movements of prices varied greatly among the important commodities whereas the rate of taxation of these goods did not so vary. Moreover, as the monthly index given below would show, prices moved up and down steadily and not violently as may be expected if the excess profits tax had been shifted.

TABLE XXV

WHOLESALE PRICES †

Monthly fluctuations of the Index Numbers of 45 Commodities 1867–77 = 100.

	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Year's Average
1914	83·5	83·8	82·8	82·3	82·3	81·2	82·4	87·9	89·3	89·8	88·8	91·6	85
1915	96·4	100·9	103·7	105·9	107·2	106·4	106·4	107·0	107·8	110·0	113·1	118·4	108
1916	123·6	127·0	130·4	134·2	135·4	131·0	130·5	134·5	134·4	141·5	150·8	154·3	136
1917	159·3	164·0	169·0	173·0	175·0	180·4	176·9	175·7	176·4	180·6	182·9	185·1	175
1918	186·2	187·3	188·0	189·8	191·1	192·3	192·9	195·9	197·1	197·8	195·3	196·0	192
1919	192·1	187·5	184·7	184·6	194·6	199·4	206·4	212·7	214·8	224·3	231·0	235·2	206
1920	245·3	260·4	261·8	266·1	260·0	255·7	254·6	253·5	248·7	239·9	223·8	207·2	251
1921	197·2	183·0	177·2	169·8	162·2	155·8	158·2	154·3	149·4	138·4	136·7	133·6	155
1922	132·5	132·2	133·3	134·8	135·5	135·6	134·0	129·6	127·9	130·1	130·6	129·1	131
1923	130·2	131·9	132·7	134·0	132·2	127·9	124·8	125·0	127·8	127·7	132·4	133·2	129

† *J.R.St. S.* Vol. 104, Pt. IV. Page 349.

It is therefore, possible to argue that prices rose because of other factors such as market and currency changes regulated by government control, price fixing, rationing, and subsidy. It may be noted how in 1918 when the rate of *the tax was lowered*, *prices rose* by about 14 points and would have *risen* more, instead of being reduced but for government action. "It is at this period of relatively stationary prices that those of many articles were controlled, and as a preliminary generalisation it may be suggested that *control checked the rise of prices* effectively, whatever its effects on supply while on its removal an increase at least as rapid as during the early years of the war took place."[22]

The Experience of India

The foregoing conclusion that that there does not appear to be much correlation between the excess profits tax and price is supported by Indian experienee. The excess profits tax was introduced in April 1919. But by then prices had risen by 78 points and in 1919 alone they rose by a further 51. The rate of the tax was 50 per cent of the excess and the levy was abolished in 1920. Between 1919 and 1920 prices rose by 5 points but fell by 45 points in the next year. The rise between 1913 and 1920 is explained by Vakil and Muranjan as follows ;[23] "Notes and deposit currency together rose from 120 crores in 1913 to 282 crores in 1920, thus recording an increase of more than 135 per cent. And the price level responded by the corresponding leap of 133 per cent." The price advances during the 1914 war are no doubt commonly regarded as primarily monetary phenomena all over the world and it is probable that India was no exception to it. It is, however, difficult to believe, as suggested above, that there has been mathematical correspondence between money and prices, for there appear to have been other influences at work such as

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22. A.L. Bowley *Prices and Wages in the United Kingdom* 1914—20 P. 8. (Carnegie Endowment,)

23. *Currency and Prices in India.* P. 339.

curtailment of production of some types and increase in the demand for goods.[24] But this is not our concern here. The want of correlation between the excess profits tax, its levy and rates on the one hand and price fluctuations on the other casts serious doubt on whether the tax had anything to do with the increased prices. That prices rose even before the tax, that they were rising even when the rate of the tax was steady and that they fell in spite of the tax are suggestive of the inference drawn above. The apparent increase by 51 points between 1918 and 1919 is probably explained by increased demand for our goods by the erstwhile enemy countries after the war and before their rehabilitation.

The Case of Canada

Before the tax was introduced in Canada, prices had already gone up and in the year preceding the tax, the tendency of prices to shoot up had already begun. By 1916, prices had increased by more than 30 per cent, the increase in 1915-16 alone being 21 points. In 1916 the rate of the tax was 25 per cent. of the excess, while in the next year a progressive rate was introduced going up to 75 per cent which was maintained till 1920 when concessions were given, the slab system introduced and the maximum rate reduced to 60 per cent. But prices increased by 47 points in 1916-17 and only 20 in 1917-18 when the rate of the tax was *highest*. Inspite of the maintenance of this rate for 3 years prices shot up by 45 points between 1918 and 1920, indicating that the steadiness of the tax rate did not steady the prices. For the year 1920 the maximum rate was reduced to 60 per cent and the fall in prices by about 71 points in a single year could not be due to the slight reduction in the tax rate but to the general tendency in the world; e. g. in Great Britain prices fell by 113 points in 1920-21 although the tax was maintained at the *enhanced* rate

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24. Vide Holbrok Working: War and commodity prices. *J.A.St.A.* 1940 pp. 312, 318-19.

of 60 per cent. Thus, the fluctuations in prices were probably the result of causes other than the tax.

The Experience of the United States of America [25]

In the United States of America experience has not been different although the prices rose not only later but also more slowly, and during the whole period kept to a lower level than in Canada, England, and France. Prior to the first levy of a general excess profits tax in March 1917, prices had risen from 97 in 1914 to 170 in 1917. The rise, in fact, began in the middle of 1915 on account of the large English and French orders for war materials, and this demand infected the United States with the rise which had began earlier in those countries.[26] There was in 1916 a Munition Manufacturers levy of $12\frac{1}{2}$ per cent but that was too particular a tax to affect the general price level. The March 1917 tax did not really operate. It was only in October 1917 that a progressive tax varying from 20 to 60 per cent of the excess was levied. This rate was raised by the Revenue Act of 1918 to 80 per cent. Meanwhile, prices had gone up from 170 to 203. Between 1919 and 1921 the tax was reduced to a maximum of 40 per cent but prices remained steady at 203-204 for 3 years from 1918 to 1920, but came down suddenly in 1921 to 123. The chief factor in keeping the prices steady was price control. " Without price-fixing, there is no reason why these prices should not have continued to advance and along with them the general level of prices." Thus, prices did not come down when the tax was reduced. It may be noticed how prices went up from 123 in 1921 to 151 in 1925 although the tax had been abolished in 1921.

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25. See the interesting article by D. Friday: Prices and Excess Profits Taxes (*Annals* Vol. LXXXIX, 1920, pp. 163—169).

26. Prices during the War by W. W. Stewart (*J.A.St.A.* 1920—21, p. 309) Stewart's index gives different figures from those of Bradstreets followed by me, but the trend is indentical.

The foregoing analysis of the trend of prices does not indicate any correspondence between the course of the excess profits tax and that of prices. On the other hand, it substantiates the theoretical conclusion that a tax on profits, especially on excess profits, provided the exempted minimum is reasonable, is not shifted on to the consumer.

But there is a possibility that prices did rise as a consequence of the tax. To avoid paying the tax, a number of producers during the 1915 levy were stampeded into squandermania. Wasteful and unnecessary expenditure, such as abnormal increases in wages and salaries of employees and needless repairs and replacements of capital goods, was undertaken just to spite the government. And such expenses tend to increase cost and, thus, prices. But in a permnent tax–and even in a temporary one provided adequate safeguards are adopted–such an increase in price is extremely unlikely, for it would not pay the producer in the long run. Further, even if increases are possible it would not be a case of shifting a burden as the tax revenue has not been collected but it would be a case of evasion as profits are apparently reduced.

EXCESS PROFITS TAX AND PRODUCTION

The effects of a tax upon production may be considered from the standpoints of efficiency, enterprise and investment. It is widely held that the excess profits tax adversely affects efficiency of production. "It encourages", observed the Secretary of the American Treasury in his report to Congress in December 1919,[27] "wasteful expenditure, puts a premium on over-capitalisation, and a penalty on brains, energy and enterprise, discourages new ventures and confirms old ventures in their monopolies." More than two decades later, J. R. Hicks, [28] supports

27. *A.E.R.* 1920, p. 298.

28. *The Taxation of War Wealth* pp. 43 and ff.

the contention that the excess profits tax is particularly likely to damage efficiency just because it is dlrected on extra profits i.e., the margin. *The Economist* said:[29] "E.P.T. continued in peacetine would be a tax on enterprise and growth as such." An American publication of 1945[30] has stated: "The principal reason for opposing an excess profits tax during peacetime is that such a tax would interfere with the function of profits, which in normal times is that of stimulating the investment, guiding the direction of that flow and inducing reduction of costs."

This conclusion is largely founded on experience during the First World War when wastes and evasions of various types were introduced into business just to avoid the payment of the tax to the Government. Thus, for instance, renewals and replacements of machinery, even though unnecessary, were undertaken. "He who had standing timber did not cut enough to bring his profits into the excess class, even though by such restraint he could raise his price on the small amount cut far into the profiteering scale. So it was with every industry where postponment was possible Only where production processes could be stopped at a loss greater than the taxes, or when the profits would not run into the taxable excess class or when it was feared prices might fall and the profits be for ever lost, or when the consumer could clearly be made to bear the whole tax, did production continue and in still less cases did it make normal expansion. This was disastrous from the point of view of social welfare."[31] Fantastic expenses, for instance, advertisments similar to "every cinema proprietor putting his attendants into gold leaf at the expense of the Treasury", may have been practised. Expenditure likely to increase future profits when the tax was removed was shouldered. Salaries and

29. 29th September 1945, p. 442.

30. *A Tax Program for a Solvent America* p. 130.

31. *A.E.R.* 1920 p. 297

wages were increased temporarily, sometimes to spite the Treasury, but often on the tacit understanding that they were mere advances to be recovered when the tax was removed.[32]

The conclusions based on this experience, however, are not completely valid. A hundred per cent tax on excess profits may reduce the incentive to better production, but a lower rate would not affect efficiency, for, although the producer may not benefit fully by improvements, he at least gains in part. As the British Chancellor of the Exchequer stated in 1939, "one thing inferred from that experience [1915-21] is that you must not put up the duty to so high a figure that what they spend really becomes a matter of no importance to people, because they get so little themselves."[33] The criticism, therefore, is applicable to the very high rate of taxation and low normal profits allowed. And this would be true of any other tax, e.g. the income tax, if the tax rate is excessive. No businessman is permanently prepared to cut off his nose to spite the face, by refusing to improve the productive process because he has to share the gains. Such squandermania is essentially associated with a temporary tax. If the levy is permanent it would be only a foolish producer who would waste his profits in this way, for, he would not gain thereby. Moreover, wastes such as unnecessary renewals and replacements cannot be continuous–the producer cannot replace his machinery every year or two. Again, some methods of evasion, such as increasing wages, even if permanent, would not be undesirable as they would save a great deal of social security expenditure, especially when improvement of labour conditions is an important aspect of social reform. Finally, much of these wastes and evasions

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32. Hicks, *op. cit.*

33. Consideration of the Finance Bill No. 2. of 1939, House of Common Committee, 4th Oct. 1939.

has been and can be counteracted by proper legislative provisions. As the *Economist* put it,[34] it should not be beyond the competence of revenue authorities armed with the experience acquired so far to prevent its repetition.

One of the simplest methods of reducing waste and encouraging efficiency is the adoption of a reasonable and even high effective rate of exempted normal profits. It may not be necessary completely to prevent excess profits from arising, for, they depend upon factors beyond the control of any administration short of a Collectivist State; but an equitable and flexible normal rate based on the factors mentioned in a previous chapter and taxation of the excess at a moderate rate of about 20 to 40 per cent would not only prevent the growth of inefficiency but would stimulate further improvements in production. So long as there is some financial incentive open, productive efficiency is goaded to increase itself in order to make up the portion taken away by the state.

Profits, no doubt, are the hub of the modern economic system. As Hargreaves Parkinson puts it,[35] " There are a hundred and one ways of describing profits. They are the goal of business efforts, the fountain of dividends, the basis of stock exchange values aud the raw material of budget surpluses. They are both the stimulus and the reward of successful business administration. They determine in the last resort the location of industry, the organisation of labour and the size of the business movement. They are a lodestone drawing men to great cities or tropical deserts· The are a key to unlock the treasure chests of investors. Without them, black type has not prospectus appeal and company balance sheet valuation and capital assets

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34. 1st June 1940, p. 970.

35, *The Economist*, 17th December 1938, p, 597

have no meaning." If the profit motive is completely dried up and all profits are prevented from accruing, not only would efficiency probably suffer, but stagnation and even deterioration in production may result. The excess profits tax, however, does not propose to prevent all profits but only to take away a portion of extraordinary profits if and when they arise. In other words, it tries to distinguish earned efficiency profits from unearned scarcity profits.[36] The former are what the entrepreneur receives because of his peculiar dynamic efficiency in controlling the destiny of capital, incorporating ideas into industry and in assuming risks in connection with them. The latter, unearned profits, are various gains of the scarcity increment type arising from an increased intensity of demand forces which may be due to natural market fluctuations, monopoly, restraint of trade or exploitation of the consumer. Obviously, therefore, where efficiency is provided for the producer will not ordinarily relax in his efforts.

Analysing a progressive business–Cadburry's–the *Economist* observed,[37] " A study of the most progressive and successful modern enterprises suggests that the greatest achievements of capitalism are often accomplished in response to a more subtle stimulus than that of the mere expectation of profit. . . . . Capitalism, perhaps, works best, even within its own definitions, when the profit motive is reinforced by something like the wish to serve. . . . . It is as foolish to condemn production for profit, where the profit is merely the sign that the entrepreneur's job has been done successfully, as it is to extol the profit motive as a universal specific for a world where profits may merely be the fruits of monopoly."

It must, however, be remembered that efficiency is

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36. *Vide* C. J. Foreman ; A division among theorists in their analysis of Profits. (*Q.J.E.* 1919, pp. 114—137).

37. 31st March 1945, pp. 417—418.

essentially a relative term and its connotation is liable to differing interpretations. We might accept A.L. Bowley's interpretation[38] that the less the effort wasted, the greater is the efficiency, and that in dealing with the economy of a society, the effort to be measured is the aggregate put forth by all its members and the result, the provision of all these goods and services that are held to be desirable. Efficiency in manufacture, for instance, would include the most economical use of the best machinery, good co-ordination of processes, careful adaptation of tasks in the best physical conditions to suitably trained workers, cost accounting and acute intelligent management. Generally, this shows itself in larger output and lower costs. These would not be affected by the kind of tax suggested above. In fact, it may, like capital taxation, perhaps be the best way to stimulate business and unemployment.[39]

Effect on enterprise

These conclusions point the answer to the second of the problems, namely, the effect on enterprise. As in the case of efficiency so also in that of enterprise and investment, there is a widespread belief that the tax has a deterimental effect. "The confiscation of profits or a large part of them and the scattering of these funds to the lower income group," writes Carl Snyder,[40] "must extinguish the capital supply hitherto available for reproductive enterprise." Such a distinguished authority as Seligman also believed[41] that a tax of the Capital Standard variety was best calculated to repress industry, to check enterprise in its very inception and to confer artificial advantage on large and well-established concerns. A similar

38. A. L. Bowley: Production and Efficiency. (*J.R.St.S.* 1939, pp. 1—20).

39. Compare M. Kalecki. A theory of commodity, income and capital taxation; (*E.J.* 1937, pp. 444—450.)

40. *Capitalism the Creator* (New York, 1940) p. 275.

opinion was stated by another taxation expert in the words[42] that the excess profits tax restrains production, enhances the cost of living and, in general, hampers industrial reconstruction, and that the anticipated removal of the tax quite as such as the high rate of the tax causes this discouragement of industry. According to the *Economist*[43] the tax injures enterprise as all the risks fall on the manufacturer, the builder the merchant or whoever takes the risk associated with enterprise. "It is a case of government saying Heads we win. tails you lose." In the language of economics, the tax falls directly on the *margin* where it will do most damage.

These fears are much less true of the excess profits tax than of many others now in vogue.[44] For, the Golden Rule in taxation is not to levy it until the profit has emerged; the taxation of losses inevitably leads to lack of enterprise and unemployment.[45] Thus, only a tax that has to be paid in any event-win or lose-actually increases the risk of loss in the transaction and exerts a considerable deterrant effect. This conclusion applies with great force to taxes other than a levy on abnormal gains.[46] The fear that damage would be done at the margin of enterprise would perhaps be true if profits in real life were determined by competitive conditions and were, thus, the true return for only differential ability. Under imperfect competition and monopoly which characterise the real market, profits are very much

42. *A.E.R.* 1920, p. 297.

43. 4th January 1919, p. 14.

44. Enterprise and Efficiency: *The Economist* 4th September 1943, p. 307.

45. Without necessarily agreeing with all the conclusions of D. Black, attention is drawn to pp. 209—226 of his *Incidence of Income Taxes*.

46. Compare Hugh Dalton's observation in relation to the income tax "There is plenty of evidence to show that the income tax has depressed morale and reduced incentive, and it has in the aggegate diminished production To this extent it has been a bad tax, which must be judged......as on balance undesirable in relation to its effect upon productive activity" *The Economist* 20th October 1945, p. 543.

higher than what ability demands and the excess profits tax affects them. Further, the margin could not be damaged where efficiency, and incentivel are provided for in the normal rate. But when a tax has to be paid only after the accrual of profits and especially after losses are provided for by averaging over a series of years and only if abnormal gains in terms of efficiency exist, there could possibly be no deterrant to enterprise, and the 'Golden Rule' holds completely good of the excess profits tax. It might even be claimed that, provided a fair normal rate is allowed, the trimming of abnormal gains positively encourages enterprise. For, investment and enterprise largely depend not merely upon the amount of profits that can be made but also upon the regularity and continuity with which they are made. The Harrison Committee suggested in 1918 that everything should be done to encourage industry to go ahead on its task as far as circumstances will allow and with as little anxiety as possible concerning its ability to earn profits. Pleading for ten per cent of the excess profits being allowed to be retained by industry, Lord Zetland, Governor of the National Bank of Scotland said in his chairman's address in 1940,[47] "Since profits or more accurately the prospect of profits directly regulate the volume of investment, instability of profits is a serious weakness in the economic system." Not only is an adequate return necessary but stabilising it would help enterprise. While a certain degree of variation of profits is inevitable and necessary as an incentive, violent changes as well as wide variations in profits may influence investments in such a way that the cyclical course of economic conditions becomes not only more frequent but more telling in its disturbing effects.[48] Control of return

47. *The Economist*, 21st December 1940.

48. Compare; R. Crum: Cyclical Fluctuations in Corporate Profits *R.E.S.* 1939, pp. 49-61.

within limits would reduce instability in the same way as organised markets, speculation and short selling do.[49]

Let us look at the effect on capital formation and utilsation. The supply of capital depends on real saving as well as the financial mechanism in the capital market and prospects for investments. It is high taxation and instability of returns that hamper saving. If the normal profits rate is equitable, as suggested earlier,[50] and the rate of taxation is moderate there does not appear to be any discouragement to saving. Moreover, the more fully the maintenance of capital is provided for, the greater will be the willin gness to bring it into existence.[51] This demands an adequate depreciation allowance.[52] Saving is stimulated also by relief for profits ploughed back into additional productive equipment, which can be provided for by linking efficiency with exempted profits.[53]

Effects on Savings

What is more important is the way in which the savings are utilised. As *The Economist* put it[54] " For a bold and positive prosperity policy two things are necessary, first, there should be adequate profits to attract and reward investments in productive equipment and, secondly, there should be most powerful and unremitting pressure to reduce costs of production so that every keen mind and industry is on the alert to discover means whereby capital can be used to reduce human toil–the mechanism of progress." To realise this and to encourage productive use of resources

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49. Compare: M. J. Fields; Speculation and the stability of prices: *Q.J.E.* 1933, pp, 357-367. "The E.P.T.", wrote *The Economist* in 1946, "is still the great leveller, it is lopping off surplus earnings and stabilising dividends." 20th Feb. 1946.

50. *Supra* P. 168

51. *Vide* The Supply of capital *The Economist* 2nd Sept 1944 pp 308 and ff

52. *Supra* PP. 198 and ff.

53. *Supra PP.* 168 and ff.

54. 9th September 1944 P. 342

an indiscriminate release of profits, which the absence of a profits tax would result in, will not help. Even if the wastage of profits in dividends is prevented it would still lead, from the social point of view, to wastage in equipping industry for unessential rather than necessary production. Proper use of profits, therefore, can be achieved by a purposive direction of investment and a proper provision to accelerate the modernisation of plant and equipment. The growth of productivity depends on the rate of technological progress and on the rapid translation of new ideas and inventions into new tools and commercial practice. This demands liberal depreciation and research allowances so as to induce firms to direct their savings into channels accelerating industrial productivity. It has been suggested earlier how opportunity should be given for research and experiment and replacement of plant, not when it is physically obsolete, but economically obsolete. It is not, therefore, the tax as such but the way in which it is administered and framed that may affect production.

Another effect to which pointed attention has been drawn recently is in relation to inflation.[55] Two aspects of such effects can be noted, (i) the influence of *E.P.T. on inflation* and (ii) the consequences of *inflation on E.P.T*, and on business. The tax is considered to influence inflation both ways: It checks inflation so far as it reduces private savings by reducing disposable income, and, so, business expenditure, out of undistributed profits and by checking business loans when the rate of taxation is high. At the same time, it tends to increase inflation because of increased business expenditure, e.g., higher wages as evasionary tactics.

More important are the anticipated harmful effects of inflation on the tax and through it on the community. It is stated that inflationary profits,

55. Hicks: *The Taxation of War Wealth*, Ch. VII

although they may be high in terms of money and, therefore, liable to E.P.T., may not at all be high in real terms, because their real value is cut down by high prices. "Profits rise not in proportion to the rise in prices but more than in proportion; because they are calculated as a difference between selling prices (measured at one level of prices) and costs (measured at a lower level)."[56]

This fear is only partially true. Inflationary and real profits, no doubt, differ, but the course of prices and profits in India between 1939 and 1943 is suggestive :

	1939	1940	1941	1942	1343
Index no. of net profits	100	127	282	259	327
,, ,, general prices	100	116	129	158	217

Inflation was greater in India than in U.K. or U.S.A. All the same, it can be seen that real profits have increased more than the prices. "The profit index," to quote my conclusions in another connection,[57] "has outstripped the price index, indicating that while inflationary prices have contributed their share of increased profits, there has been real improvement in earnings resulting largely from the increased demand for the reduced supply. It may also be emphasised that the trend of profits has been different in different industries–certainly an untenable position if the industrial improvement since 1939 had been even largely the outcome of inflation." The conclusion is inevitable that the abnormal war conditions have definitely benefitted the producer.

Hicks, however, adds that profits calculated in this way may not really measure the net gain to industry. For, the working capital in terms of money would be

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56. *Ibid*, P. 57

57. M. H Gopal : Industrial profits since 1939. (*The Eastern Economist*, 12th May 1944 P. 732,)

unchanged, and depreciation of fixed capital being calculated on the original cost would be insufficient to replace the assets since prices of fixed equipment would have risen. Whereas the firm should have put its profits in reserve so as to return to normal activity after the emergency–war or inflation–it is prevented by the E.P.T. from accumulating such reserves. This would mean that since prices have risen, the tax eats into the capital of the firm and would in effect become a simple tax on profits which, economically considered, are capital rather than income. "An E.P.T. begins to acquire some of the characteristics of a capital levy—a bad sort of capital levy." [58] From this the conclusion is drawn that the original proprietors suffer since the real value of capital is reduced, and so also the creditors and debenture holders since theirs is a fixed interest obligation which, though constant in money terms, would be reduced in real terms. Finally, it is suggested that the evils in the upswing will not be evened out in a depression. For, any reserves that might have been built up in an upswing are not so much for refinancing as to meet the fall in prices. In the United Kingdom and Italy it was succeeded by the losses of deflation and the reserves which ought to have gone down to cover these losses had been collected by the state or were earmarked for such taxation. Finally, Hicks concludes that in Italy the attempt to secure social justice by stopping the activity of industry had made Fascism inevitable.

Whatever the truth of these charges in an emergency tax, (and specially prior to 1944), many of them are either inapplicable or insignificant in a permanent levy. The effects on reserve formation can be alleviated by a liberal depreciation policy as suggested in Chapter IV *ante* or as adopted in Great Britain and other countries in 1944–45. There is nothing

58. Hicks *Op.Cit*, P. 57

inherently productive of this evil in the tax but it was inadequate depreciation provision that has been responsible. Further, the adoption of a sliding scale would obviate any harmful effect on capital.[59] Moreover, the creditors and debenture holders suffer not because of the tax, which does not in any way reduce their dues, but because of inflation and the fixed nature of their return. Supposing there were no excess profits tax but inflation, the debenture holders would all the same, get a reduced real return. They would gain in real terms when prices fell in periods of deflation or depression. None of the consequences pointed out by Hicks appears to be peculiar to or inherent in the excess profits tax. They are essentially defects of the current structure of the tax and only a process of experience and evolution can set right the defects, as in the case of any other levy.

PLANNING AND THE EXCESS PROFITS TAX

The Objective of Planning[60]

In considering the place of the excess profits tax in national planning, I shall analyse the object of planning in order to get a correct perspective of how exactly the tax fits into the plan. The greatest paradox in human history has been the prevalence of privation and misery in a world of immense economic resources and productive powers. This paradox is the outcome of the capitalistic system, uncontrolled and planless, guided by effective demand rather than social need and trying to attain the goal of minimum individual cost and maximum private profit. Capitalism is characterised by lack of coordination in economic processes and by a deep divergence between the movement of

59. *Supra* PP 202-204.

60. See specially *World Social and Economic Planning*, International Relations Institute, Hague: *What is wrong with the Economic System* by A. W. Knight; *Readings in Economic Planning* by J. George Frederick and the numerous articles by various writers in *Annals* Vol. 162, July 1932. I have freely drawn upon these and other writings.

production and the movement of the purchasing power of the masses, It has, thus, partly failed to achieve the social end. viz. the optimisation of communal welfare. For a long time the fundamental economic and social institutions of the West are being modified, corrected and readjusted from an individualistic to a socialistic basis, a change accelerated by the last two Great Wars. We are to-day experiencing a world wide process of social change from the unlimited economic and social individualism of the nineteenth century to new and as yet not fully perceived economic forms of the twentieth century. But it is clear that a regularisation of our economy is necessary and a new functional economic organisation is inevitable.

The new method of co-ordinating and balancing production and distribution is Economic Planning. Instead of allowing such co-ordination to work itself out automatically through exchange processes and the operation of prices and profits, it tries to exercise a rational and unified guidance in adjusting available resources to real needs. In a way, it is merely the transfer of the technique of scientific management from the field of individual enterprise to that of social economics. It does not attempt to solve all questions of economic and social life, for, it can become a conscious method of operation only when used in relation to a clear plan of social purpose and development. From the production point of view, however, planning involves a reallocation of social resources among the different goods and services so that there is an optimum utilisation of factors at minimum social cost and with maximum social benefit—a condition absent under capitalism. From the standpoint of distribution planning attempts a reallocation of income so as to reduce inequalities by increasing purchasing power in the hands of the bulk of the population whose standards of living must be improved. Such distributive reform can be achieved in one of the following ways: (1) by reducing the prices of finished goods so that real income might increase

even with the available nominal resources. This would involve the problem of production. (2) By socialisation of industries and the supply of goods and services below cost as in the case of education and medical relief. (3) By financial assistance to the masses in the form of subsidies of various sorts—e.g. unemployment and poor relief, social security schemes of various types—largely in the nature of consumers' subsidies. The last of these which is germane to our study here, involves the raising of revenues, and the excess profits tax offers one such source of income to the State.

Confining our attention to the problem of production: the need for a change in the present system of capitalistic production is obvious. I am not, however, prepared to believe that complete socialisation as in the U.S.S.R. is *at present the only* alternative to capitalism. For, such a revolutionary change is neither possible in all environments nor perhaps desirable. After all, planning is "a procedure for positing a socio-economic goal marshalling resources for its attainment, applying appropriate techniques and releasing essential human energies." It is not, therefore, merely aa engineering or an economic feat. It is essentially a psychological one, that is, a scheme for redirecting individual human behaviour in terms of a reintegrated collective purpose. Behind all economic questions is human nature, and so long as there is a special instinct of self preservation showing itself in self-interest it is difficult to convert overnight profit-seeking men into labourers for the good of society. Even in the Soviet system the profit aspect has not completely disappeared. There is considerable money economy in U.S.S.R. Sale of goods for profits is allowed to a limited extent and a profit and loss book-keeping system is insisted upon in each productive unit. This obviously is a realisation of the fact that there must be some recognition of self interest and some constant stimulus to ingenuity and action.

All plans, therefore, need not be of the Soviet type nor all economic initiative of the opportunity to make unlimited profits. Many basic economic processes to-day—such as determination of wages, discount rates, saving and, during abnormal times, investments, foreign trade and prices are carried on under conditions of public control and collective bargaining and could be imported easily into a system of planful activity without much difficulty. We want an organisation of industry as will stabilise a surplus economy modifying but not sacrificing the values inherent in individual initiative and self expression, thus bridging individualism and collectivism and giving rise to a new form of economic system which is neither capitalistic nor socialistic. We might call this, as Lorwin does, the Social Progressive Type of Planned Economy. It envisages the possibility of unified direction without a dictatorship and without abolishing completely the rights and institutions of private property. It involves planful control by limiting powers of individual and corporate enterprises and subjecting the making of profits to social ends. Such control would eliminate entirely individual and group initiative and would not call for an imediate collectivisation of industry.

There is essentially a way of modifying capitalism and removing from it its fangs. For, individualistic enterprise has constructed a magnificient economic machine which must be utilised to organise and manage production for social purposes. It is necessary not only to retain but to increase initiative and enterprise, as on these depends largely all economic advance in productive methods. The quest for profit has been the motivating factor in the present economy. But uncontrolled monopoly and unregulated competition have led the world into a drift economy. While, therefore, the motive must be maintained, it must at the same time be bridled. To move from drift to controlled direction we must utilise as many of our acquired habits as

possible, for social change after all is a process, often a slow process. Therefore, while there must be an effective break with the traditional conception of profits, profits as payments of management and as an inducement to industry must remain, though they must of necessity be limited and regularised i.e. we should admit the reality of human nature and the essential part individualism and competitive private profit play in any economy. If social welfare is to be the general objective the quest for financial profits must be made a by-product instead of unlimited production being undertaken for the maintenance of profits and values, with satisfaction of social needs as the by-product. In its larger aspect the profit motive is certainly dangerous, for, it not only hinders optimum production but prevents the proper flow of income to consumers. Its usefulness, however, in controlling details has been proved. The whole seemingly complex structure of our economic projects can be organised about the central idea of distribution and employment of profits ; and the multiplicity of details which would otherwise overwhelm the planner can safely be left to the automatic action of the profit motive if we controlled its *major* activities. If profits were stabilised, there will be a wiser and wider disposition of them. It is the sudden emergence of excessive profits that unbalances the entrepreneur's judgment and leads to sterile applications. A tax which will prevent such excess profits is bound to divert unneeded profits, enterprise and capital into more desirable channels of production.

HOW DIVERSION CAN BE EFFECTED :

We have seen above how a readjustment of productive resources is necessary in the intetests of social welfare. There are four alternative ways of achieving this object: (1) Socialisation of production as in Russia. We have given up this method as too radical a solution at present. (2) State encouragement to industrial development in the form of bounties, subsidies, pro-

tection and similar measures followed by most countries under capitalism. This has its uses and limitations which do not concern us here. (3) Investment control. On account of abnormal conditions and the need for conserving resources and developing war industries, governments have restricted company formations and investment increases, insisting upon previous sanction being obtained before any operation is undertaken. Similar control is also found with regard to production in existing concerns also. Not only in abnormal times but under peaceful conditions also, such controls are in operation, for instance, with regard to public utility industries such as railways, gas, water and shipping, so also with regard to defence industries like munition manufacture. The obvious purpose of such control is the diversion of capital and enterprise into socially beneficial channels.

An equally effective but less irritative way of diverting invesment is by means of taxation. Of the two weapons that the government controls to create full employment, the taxation weapon, as *The Economist* observed[61] "is, potentially, far more powerful than any direct controls . . . What is relevant to the stabilisation of capital expenditure is that taxation of industry, whether high or low, should be varied from year to year in accordance with the needs of the general economic situation." Taxes on business generally affect production, often restricting the output. They have often been levied to achieve this purpose. Thus, for instance, the notorious cotton excise duty in India was apparently imposed for revenue purposes but really to arrest the development of the Indian textile industry in the interests of Lancashire. Similarly, the sugar excise was levied, when the administration felt that the industry had expanded sufficiently and that a further growth would be superfluous and even dangerous. Such instances

61. Captial and employment: *The Economist* 10th June 1944. p 771.

plentiful as they are, emphasise how taxation can be utilised to achieve a non-revenue end. Restriction, however, is bound to result not only in preventing further growth of the taxed industry but also in accelerating the development of other industries. For, if anything characterises enterprise it is irrepressibility. The entrepreneur cannot sit idle. He must direct his energies in some other direction if he can not proceed in the old line. Similarly capital cannot remain dormant for any length of time. It must be invested and it must earn a return. Idle capital would result in lower interest and thus an impetus would arise for its employment. Enterprise and capital are similar to a liquid which must find its own level. As a river dammed in one direction necessarily spreads itself out trying to find an outlet elsewhere, so also capital and enterprise restricted from expanding in one industry will try to force a way out in other untaxed or less taxed industries. That is, they shift themselves to occupations which offer easier and higher returns. Such a consequence of the mobility of the factors is an obvious fact.[62]

This kind of diversion may be territorial or occupational, that is, factors may move out of the taxed territory into untaxed ones ; for example, much of British foreign investment is partly traceable to higher taxation at home and, of course, partly to the greater opportunities abroad. The inter-state movement of industries in America on account of State taxation is another illustration of territorial mobility. Obviously, such diversion is sometimes undesirable and must be countered by restrictions on the movement

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62. This is similar to the *Economist's* comment on a Special Development Account: " A lower effective rate of tax on funds spent on capital formation should take the form of a rebate of tax granted when funds are drawn out of reserve and spent........Can it be doubted that such an instrument' would be a powerful and flexible incentive to promote the optimum flow of new capital formation when it is most needed and damp it down (if necessary by a surcharge of tax) when it is not." (26th January 1946. p. 215.)

of factors. We need only note here how tax concessions attract enterprise and investment and tax imposition drives them out. It is interesting to follow the effect of the recent Futures Conrol Order under the Defence of India Rules. When the prohibition was introduced and the futures market closed, the price of gold went up, because erstwhile investors in the futures turned from cotton to gold, though the latter was certainly less speculative and, therefore, less profitable. Just as nature abhors a void, so the speculator and investor preferred the less paying gold to the idle market. But when the restriction was withdrawn and the more profitable and speculative market was opened, gold fell in price because investments now moved away from the less paying gold market.

This diversionary effect of taxation has certain disadvantages in all taxes except the excess profits tax, and it is this exceptional feature that makes this tax so desirable and useful in planning production under capitalism. The other taxes in general reduce output and thus raise prices. Consequently, they affect not only production but also consumption, whereas our object in diverting investment is to balance production and to increase consumption. Further, where such shifting is possible and the producer can realise the increased tax burden from the prices, he may not divert his energies elsewhere as the tax does not affect him. On the other hand, the excess profits tax has none of these drawbacks. I have pointed out already how the tax cannot be shifted. Consequently the producer himself will have to face the music and share his profits. Where only the more fortunate producer will pay, output will not necessarily be reduced. A variation in the normal tax rate as between the different industries will naturally divert enterprise where the profits are higher. Supposing we have in India an adequate development of the cotton textiles but inadequate growth of the iron and steel industry, a lower rate of exemption in cotton and

a higher rate in iron would naturally divert resources from cotton to iron. What exactly are the attractive and the restrictive rates may be determined by investigation by a body like the Investment Board. If a more rapid development of the iron industry is necessary a raising of the normal percentage would serve the purpose. This operation of the excess profits tax is like that of a valve in a pipeline or a sluice in a reservoir.

We need not fear an unhealthy diversion from the textile to the iron industry, for, capital already invested cannot easily be moved into another industry as modern capital is highly specialised. Further, if the effective normal rate for cotton is liberal enough, investments already made will not be induced to forsake the old line. It is only new enterprise and new capital that will flow into the iron industry, instead of into cotton. We need not also fear industrial stagnation. I have discussed this point elsewhere in this chapter. It might be pointed out here that when the tax is permanent, the normal rate is liberal and the tax is not hundred per cent, there is sufficient inducement for the producer to improve production, for he gets a part of the excess profits. Thus we find that a variation of the exempted minimum will naturally lead to a healthy diversion of investments and the sharing of the excess profits by the producer will not deter improvements. It is for the state planning authorities to determine the extent and direction of industrial development and to decide which new industries should be started and which old ones restricted. The administrative authority, like the Board of Referees in England, will suggest the effective normal rate of profits in different industries and, if necessary why a tax should not be levied at all on a particular industry. Thus, for instance, the normal rate varied from 6 per cent to 29½ per cent in England during the 1915 levy of the tax, while under the National Defence Contribution of 1937, the levy could be remitted in whole or in

part if such a concession was necessary for the establishment of particular individual undertakings. With the outline thus determined, the actual starting and working of enterprises might be left to individuals. This procedure would retain much of the present freedom of enterprise and incentive to improvement and at the same time regularise, control and direct economic development, thus interlacing private enterprise and public control, though not at every point.

This device for adjusting industrial growth might be applied with equal effect to regional planning. Supposing a dispersal of industries is necessary and the planning authority desires the industrialisation of the Central Provinces and does not favour further expansion in Bengal, a higher rate in C. P. so far as the normal level goes would achieve this object. Thus, the excess profits tax could be used for regional as well as occupational planning. Thus the main purpose of the British Special Areas Legislation, viz. a more balanced and diversified industrial development in areas which, because of their dependence on a few industries, are exceptionally liable to unemployment, can be more easily achieved by the tax. For, "the general principle of using the machinery of differential taxation to direct, stimulate and, if need be, retard the flow of new investment, is admittedly desirable. Indeed, it is perhaps one of the best means to these ends."[63]

My suggestion resembles K. E. Poole's plea [64] for tax- remissions as a means of influencing cyclical fluctuations. A purely automatic system of government subsidy to investment may be dangerous and lead to excess capacity and over-investment, while public investment must be simultaneously accompanied by private investment. The remission of production restraining taxes is considered by Poole as stimulating

63. *The Economist*, 30th January 1943, p. 149

64. *Q.J.E.* 1939, pp. 261—274

production and investment either through the creation of credit or by the putting into use of idle funds. The remission may be made contingent on the course taken by the industry, such as increased production, increased plant capacity, etc. Poole also feels that the concession may be made at an earlier stage of the industry, e.g. ginning, so that it would lower costs later.

This method was tried in pre-Nazi Germany by Von Papen's administration but was not a success perhaps because of the smallness of the tax remission.

This scheme has some outstanding defects, Firstly, it is inflexible. There is no logical connection, as Poole himself admits, between the amount of taxes and the extent to which a given company needs to be subsidised in order to find it profitable to expand operations. Further, 'Investment thus created lacks important characteristics of spontaneous entrepreneurship'. Moreover, it involves a definite loss of revenue which could have been utilised for further encouragement of industry or other social purposes.

The excess profits tax has few of these drawbacks. The great flexibility in the normal rate of profits makes it extremely adjustible; the tax gives complete scope for spontaneous enterprise within the planned economy. More than all, so long as excess profits are inevitable, it yields revenue which is available for furthering other schemes and would provide a 'Social Security Contribution.' The tax would thus become a unique instrument affording "room both for constructive experiments in the technique of collective organisation and also for the freedom and the dynamism of private enterprise."

CHAPTER VI

Objections and Alternatives

OBJECTIONS

No tax has escaped criticism but none has been so vehemently objected to as the excess profits tax. It has been attacked from all sides—equity, effects and administration. The fundamental objections on grounds of equity pertain to the inequitable distribution of the burden. The most serious criticisms, however, relate to the effects—that the tax curbs initiative, retards investments, increases prices and puts a premium on inefficiency and waste. The administrative complications are stated to be the difficulty of determining a profits' norm, of valuing invested capital, of preventing over-capitalisation and evasion, of administrative intricacy and of the interference with the income tax.[1]

Standpoint of equity

Let us consider these criticisms. The tax is regarded as giving rise to inequity between industries and between individual concerns, since all of them might not be in the same stage of development or business prosperity in the standard period. In the words of *The Economist*:[2] "No general objection in principle has been offered to a tax on the growth of profits as such, with the important reservation that companies pursuing a steady course of prosperity feel its incidence least. But the root technical difficulty in taxing any growth of profit is to ensure that the basic standard from which such a growth is measured shall be reasonable and

1. T. S. Adams: Should the excess profits tax be repealed? *Q.J.E.* 1921 pp. 363-393, succinctly states the objections. Also see Buehler: *Public Finance* pp. 542 and ff; Lutz: *A Tax Programme for a Solvent America* pp. 128 and ff.

2. 13 th April 1940 p. 675.

fair to the taxpayer without prejudicing the revenue getting potentialities of the tax. This is the major objection." This criticism obviously applies to the Income Standard or even where there are alternative standards; but under the "Flexible Capital Standard" advocated in Chapter IV, a great deal of discrimination can be avoided.

J. R. Hicks, however, considers the Capital Standard variety as the greater evil. "One must conclude", he writes,[3] "that an E.P.T. of the high profits variety is necessarily a bad tax, because its discrimination among firms does not offer any basis for the equitable distribution of the tax burden among persons." "The real trouble about a high profits tax—is that it must fall to a considerable extent upon the wrong people." He pleads for a proportional tax levied when dividends are distributed. "This is the solution to which the Americans did come in the end. Their excess profits tax was replaced in 1921 by a surcharge on the ordinary corporation profits tax."[4]

In Chapter IV *supra*,[5] I have discussed the relative merits of the two varieties of the abnormal profits tax and pointed out why the high profits variety is more equitablc. It may be emphasised here: first, that Hicks still holds to the universality of the ability-to-pay principle and the taxpayers' standpoint. Josiah Stamp has sufficiently proved that there are other considerations in taxation—"main principles of taxation emerging from the world experiences of to-day from three distinct points of view"—of which the tax-payer's is one.[6] Secondly, America abandoned the excess profits tax for really a different reason altogether. Whatever the apparent cause,—certainly the tax had administrative draw-

3. *The Taxation of War Wealth* p. 38.
4. Ibid: Also see p. 42.
5. *Supra* pp. 140 and ff.
6. *Fundamental Principles:* P. 215.

backs and the Treasury expert opined that it worked unequally between different organisations—the real position was that the tax became a party affair and was opposed by "an organised propaganda that appeared to have the unlimited financial backing and moral support of the business interests of the nation."[7] "The propaganda for its repeal has been so widespread, so prolonged and apparently so well financed and interested . . ."[8] A couple of years later, in 1924, Blakey, the commentator on the Revenue Acts, stated[9] that its condemnation was unreasoning and at thc behest of powerful interests. After a detailed investigation into the working of the tax in Great Britain, R. M. Haig, the American expert, observed[10] that "the best British opinion preferred the Capital Standard Variety."

Finally, it is true that the tax when first levied would fall heavily on the stockholders; but this is true of all new taxes and of all changes in the rates/of existing ones as the economic equilibrium is disturbed by the novelty of the impact.[11] If Hicks' contention is accepted, all changes in taxation are indefensible. After all, a certain amount of inequality is inevitable, not only in the application of this tax but even of such an ideal impost as the income tax. The amendments and modifications of income tax laws are largely directed towards making that tax more equitable and less intricate. Very recently *The Economist* commented on the British income tax, which is one of the least imperfect in the world and which has had a long life of a century and a half:[12] "Reform of the income tax structure has long been recognised as necessary because of its extreme complexity, and Mr.

7. The Revenue Act of 1921 (*A.E.R.* March, P. 75.)
8. *Ibid* p. 93.
9. The Revenue Act of 1924 (*A.E.R.* 1924, p. 498).
10. *Report on Excess Profits Taxation in Great Britain*, p. 174.
11. Vide Seligman: The Effects of Taxation, *P.S.Q.* 1923.
12. 5th January 1946 p. 21.

Dalton has already declared his intention to classify codify and clean it up." Pointing out that taxation should fill a new role in stabilising employment, promoting industrial efficiency and ensuring simplicity and ease of administration the commentry concludes: "The present income tax meets none of these needs adequately and some of them not at all." Obviously, therefore, no tax can be perfect at its very inception. It is certainly impossible to achieve an ideal excess profits tax operating with complete equity on every section of business. Industry has the right to expect rough justice to be done, and it must be prepared to face the broad necessity for the excess profits tax, once its rough edges have been smoothened. Of the excess profits duty of the First World War, *The Economist* wrote [13] "During those seven years (1914-21) much trouble was involved, in turning the Duty into an efficient instrument of taxation, but by the time, this had been achieved, the day had come for its repeal. . . . Indeed, the Treasury might have spared itself and the business community a certain amount of trouble if it had foollwed the precedent of the Excess Profits Duty more closely as it did in the first version of the National Defence Contribution."

Standpoint of effects

The serious objections on grounds of the effects have been discussed at length in Chapter V. [14] It has been pointed out that it is possible to correlate the tax structure to the efficiency of the producer and the National Plan, so that the tax can be converted into a very useful instrument of individual efficiency and national development without affecting the consumer. The excess profits tax is also considered to endanger the income tax.[15] Whatever the truth of this criticism during the First World War, it cannot really hold good to-day. For, at that time in most countries

13. 13th April 1941. p. 675.
14. T. S. Adams *op. cit* p. 370,
15. *Ibid.*

excepting Great Britain the income tax also was a new levy introduced largely for revenue purposes. Making two apparently similar taxes successful–when both were new—probably meant danger to the more important of the two ; but to-day the income tax has come to stay and has had a life of more than 35 years. Income and excess profits taxes are based on different principles altogether and there could, therefore, be no conflict between the two, any more than between the land tax and an agricultural income tax or the income tax and the death duty. Finally, from the point of view of the yield, what matters is the total revenue, and, other things beings equal, the more varied the ways of plucking the goose the larger will be the yield.

Viewpoint of administration

The administrtive objections are more in number but less in importance. It is said that the tax is intricate and consequently is opposed by businessmen. But all new taxes are bound to be intricate to some extent and it is only experience of its actual working that can enable us to reduce its intricacy.

A further objection has been that the tax adminstration machinery may break down. In America, where this difficulty was particularly felt, the resignation among the tax administration officials during the First World War was said to be 100 per cent per year. " In the higher positions it is practically true to say that nearly all the best officials enter the service in the expectation of acquiring a technical education and then leaving for private practice.[16] Referring to the levy during the Second World War, Secretary Morgenthau observed before the joint Committee of the Congress:[17] " We have now a bar of registered attorneys and tax accountants numbering approximately 45,000. Against them are pitted some 2,500 field agents actively engaged in tax investiga-

16. *Ibid.*
17. The Revenue Act of 1937 (*A.E.R.* 1937, P. 698)

tion for the Government. The contest, of course, is unequal. The fees of the tax lawyers exceed by thousands of per cent. the pay of his opponents employed for the government. In this manner the most resourceful brains of the legal world are engaged actively in trying to avoid taxes for their clients. Among these are men who receive their early training from the Government and who use the skill they acquired in that service against the younger men who take their places. The Government then becomes a training goal for many of its opponents."

This defect in administration is particularly present in the United States. The roots of the disease lie deep in the American system of Government. "Here is a fundamental weakness of American Government", observed the Treasury expert at the time of the First World war:[18] "which has worried the best minds of the nation since the time of George Washington . , . . A cure will require time, much time. Ten years would be a radically short estimate of the time required in which to bring the tax-payer and the administrative authorities of the country to a point where the Excess Profits Tax could be reasonably well enforced." On the other hand, British experience has been different. The Inland Revenue not only contains officials of the finest ability and character but made the tax an unqualified success. "There was almost no bungling; outright evasion, at least during the war, was practically non-existent, and integrity as well as the intelligence of the administrative force was beyond praise."[19] Obviously, therefore, it is a matter of administrative efficiency which could be true of any tax. [20]

Another criticism has been the difficulty of

18. *Q.J.E.* 1921 P. 371

19. R.M. Haig: The Taxation of Excess Profits in Great Britain, P. 96 (*A.E.R.* 122. *Supra.*)

20. Compare T. S. Adams- Fundamental Problems of Federal Income-Taxation (*Q.J.E.* 1921, PP. 527—556)

valuing invested capital. I have suggested elsewhere[21] how this can be avoided. Yet another objection states that the tax leaves out the undistributed incomes of corporations specially by the formation of holding companies. This again is an administrative matter which an efficient staff and effective legislation can avoid. It is also emphasised that the tax is opposed to tradition. "Nothing could be devised," wrote Seligman,[22] "which would more effectively run counter to the long established policy of the American Government to the maintenance of competition." The same sentiment was put by *The Economist* [23] as follows: "It is an entirely new and rather questionable departure to introduce into the British tax system a duty whose purpose is neither to raise revenue nor to restrict the particular from of activity on which it is imposed." The purpose of taxation as well as the sanctity of the competitive economy is a matter of opinion, and we have long ago passed the stage of regarding the 19th century ideas of taxation and competition as inexhorable, unchangeable and universal.

ALTERNATIVES

Many alternatives have been suggested and some tried as substitutes or supplements to the excess profits tax. A few of these may be analysed with regard to their adequacy.[24]

The Business Profits Tax [25]

The Business Profits Tax recently introduced in India very closely resembles the excess profits tax and is meant to operate generally in normal times. In placing it before the legislature, the Indian Finance Member pointed out

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21. *Supra* PP, 174 & ff
22. *P.S.Q.* 1918, P. 30.
23. 24th June 1940, P- 700
24. Some of these have been tried in many countries but only one or two countries are mentioned below for illustrative purposes.
25. The tax is discussed in greater detail in Chapter VII. The British National Defence Contribution, though different in origin, purpose and details, was also a straight tax on profits. *Infra* ch. VIII.

that it was not purely financial in outlook but had certain social objectives, and that it represented only the first stage of a policy of social justice and development which it will require years to bring to full fruition. As pointed out below, the proposals underwent important changes in the legislature but the fundamentals have remained the same. "My most important contribution," said the Finance Member, "is the proposal to levy a special income tax of 25 per cent on business profits exceeding one lakh of rupees . . . . This proposed tax is very much more simple to operate and very much fairer in its incidence than the excess profits tax. It also embraces professions and vocations which were exempt from the excess profits tax. To prevent hardships in the case of moderate incomes. a limit of exemption of one lakh of rupees has been fixed. This, in substance, corresponds to the standard profits under the excess profits tax act, and only the excess above one lakh will be subject to a tax." The Select Committee of the legislature reduced the rate of tax to 16 2/3 per cent, gave a uniform abatement of 5 per cent on capital, defined the term so as to include paid-up capital, general reserves and borrowings but not investments. Further amendments were made, specially the rate being reduced to $12\frac{1}{2}$ per cent, before the bill became law.

The business profits tax, thus, closely resembles the excess profits tax. Its *purpose* is not purely financial. Like the excess profits tax, which it replaces, it mulcts the *extra profit*. The abatement is linked to *employed capital* and a minimum amount is exempted on the size basis.

Nevertheless, the business profits tax is neither a full fledged excess profits tax, nor a satisfactory substitute. For, it applies to professions and vocations which are *not businesses*. It is, as the Finance Member admitted, an income tax and consequently, not a pure business profits tax. Since the income tax is based on a principle different from the profits tax, the current Indian levy is a hybrid founded on a

mis-joinder of principles. Further, the abatement is uniform and not related to the varying factors such as risk, social needs and others mentioned above.[26] Consequently, there is no flexibility in it, resulting in the discouragement of the more risky businesses. This would perpetuate the prevalent defect in Indian industrial development, namely, the lopsided growth of higher yielding, less risky and less essential consumption goods industries. Moreover, as there is no co-ordination between efficiency and abatement, over-capitalisation, waste and inefficiency become inevitable. Finally, the business profits tax, in its present form, cannot be made an instrument of National Planning as described earlier.[27] The original proposal of a minimum exemption of one lakh would have been still more defective since it was extremely rigid and did not discriminate between large and small businesses.

Dividend Control

Another alternative tried in many countries has been control over dividends, either in the form of a tax or in that of dividend limitation. A recent example was that of National Socialist Germany which by the Stock Act of 1934 introduced dividend blocking in 1934[28] and continued it till 1939. Profits of 1932-33 or 6 per cent on capital, whichever was higer, was allowed and the excess had to be made over to the Gold Discount Bank and invested in government securities which were to be released sometime later, and, according to the law of 1937, in tax certificates. While the earlier German attempt of 1914–19 at dividend blocking worked successfully, that of 1934–39 did not. Both, however, closely resembled the excess profits tax but, as pointed out below, were not of the same utility.

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26. *Supra* pp. 159 and ff.

27. *Supra* pp. 235 and ff.

28. F. Wunderlich : Germany's Defence Economy (*Q.J.E.* 1938.) Earlier Imperial Germany tried it during the First World War.

A variant is the dividends tax.[29] Thus, the Nazis imposed a dividends tax in 1941 to replace the dividend limitation law of 1934. In 1945 the British Chancellor of the Exchequer seriously contemplated such a tax to replace the excess profits tax as a revenue raiser. *The Economist*[30] preferred it to the National Defence Contributon,[31] which, according to the journal, was blatantly a tax upon riskbearing and enterprise and reversed the relationship between risk capital and fixed interest capital which is desirable on economic grounds. " An excess dividend tax would have similar features but with the redeeming merit that no company need pay unless it choose. The funds, that could otherwise have been distributed, could be employed in the business or invested until the penalty was withdrawn; and if the basic dividend levels were reasonably chosen, that could be done without undue hardship to individuals and with definite social advantage."

The tax on dividends, however, has many drawbacks, both administrative and in principle. Since dividends—unlike profits—are peculiar to joint stock concerns, the tax would be inapplicable to non-shareholding enterprises which are numerous in most countries. Even in the United States of America, the proportion of profits earned by non-corporate business is considerable as evident below :—

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29. Vide Seligman : *Essays in Taxation* pp. 243 and ff for a differen approach to this tax.

30. 6th April 1946, p. 546.

31. This levy is discussed in detail in Chapfer VIII.

TABLE XXVI

Non-Corporate and Corporate Profits †

(U.S.A. 1925-42)

	§		§
1924	86·5	1933	67·2
1925	57·6	1934	54·9
1926	54·9	1935	50·2
1927	56·1	1936	85·8
1928	48·7	1937	37·7
1929	44·4	1938	52·1
1930	57·8	1939	41·3
1931	71·1	1940	51·0
1932	82·6	1941	48·3
1942	43·2		

† Data from Lutz : *A Tax Program for a Solvent America.* Table XIII p. 60. Non-corporate profits relate to those of individual and partnership concerns

§ Figures indicate non-corporate profits as per centage of corporate profits. The relative *quantum* of profits was e.g. 6565 and 10397 million dollars earned by the non-corporate group in 1924 and 1942 as compared with 7587 and 24052 millions of corporate profits in the same two years.

In less advanced countries like India, the proporation is very much larger. Such a restricted application of the control would discourage joint stock enterprises and thus reduce the advantages which gave rise to this form of business organisation in later nineteenth and early twentieth centuries, replacing partnership and single ownership types—advantages such as opportunities for small investors, the spread of risks and benefits and availability of more capital. Further, dividends are associated with share capital —equity, deferred, preference etc.,—and since employed capital includes loans and re-investments also, the entepreneur is denied his just return on such non-share capital which he has risked. An inevitable consequence is the discouragement of such methods of raising funds and the inducement to evasion. An obvious and easy method of evasion would be the issue of bonus shares,[32] whereby the law

32. *Supra.* pp. 86—88.

may be strictly adhered to in respect of the maximum rate of dividends but circumvented by increasing the number of shares held by any person and so giving him a larger benefit. The tax would, thus, defeat its very object. Finally, the ethical or social purpose of the excess profits tax would not be realised, and the dividends tax would fail to operate as an instrument either of planning or of national revenue. It is even possible that high profits may be earned and not distributed as dividends but merely held over—a situation which led to the Undistributed Profits Tax in the United States in 1936.

Investment control is of two varieties, only one of which is an alternative to the excess profits tax.

Investment Control

First, there is the mapping out of the general policy and direction of investment as a part of the National Plan. The purpose, direction and quantum of investment are determined. This form of control is *not an instrument* for carrying out the plan but a part of the plan itself. It is illustrated by the invesment planning envisaged by the British Chancellor of the Exchequer in 1945. "There is no intention," said Hugh Dalton,[32] "of compelling any one to invest his resources one way or another. In particular, the proposed legislation will not provide for the exercise of financial control over the use by business undertakings of their own cash or other existing resources." The new Capital Issue Committee did not revert to the objectionable war time technique of controlling the method as direct from the purpose of issues. The policy was physical control whose function was, in Dalton's words, "to secure that the available labour and materials are used in accordance with whatever plans may from time to time be required for the purposes of employment policy and national development." The *control over investment policy* is, thus, not an alternative to the excess profits tax.

32. Investment planning clarified. *The Economist* 1st Sept. 1945 p. 306.

The other variety, which is offered as a substitute to the excess profits tax in some of its aspects is exemplified by the British Capital Issues Committee prior to 1945 and by the Indian Capital Issues Control. Here control is more detailed and affects individual firms. An entrepreneur must obtain sanction either to start a new concern or expand an old one. In addition to the amount of capital and object of issue, the persons floating the venture are determined. The methods and details of issue are scrutinised as distinct from policy, anb a large degree of financial control exists.

Whatever its urgency and merits during an emergency, such a control is of very limited application in normal times. It is not a complete alternative to the excess profits tax since its purpose is restricted as it has no revenue yielding possibilities. Whereas the former raises revenues and is also an instrument of planning, investment control can serve only the latter purpose. And even here, it is dangerous —since permission is necessary for starting or expanding a concern, scope for nepotism and discrimination is plentiful. Preferences will have to be made among industrialists and promotors rather than industries and localities as such. Further, since sanction is rationed out, competition among enterpreneurs is eliminated and the lucky businessman is confirmed in his monopoly. It is no longer open to others to undertake competitive production. This would naturally result in the entrenchment of industrialists and of the consequent absence of stimulus to improvement and efficiency—a condition parallel to that under an indiscriminate system of protective tariffs. There would thus be no discrimination in terms of efficiency.

On the other hand, an excess profits tax, apart from its revenue possibilities, perfers industries, not individuals. Given the National Plan, entry into the production market is open to all. The normal rate of profits is fixed in relation to industries, as

modified by productive efficiency. There is little scope for individual preferences, except on the basis of efficiency. Since entry into production is free, the benefits of competition are retained and improvements stimulated.

Moreover, as periodical changes in the normal profits level as well as tax rates are possible, a great deal of flexibility can be introduced and linked to the national demand for a particular occupation or industry. Thus, while investment control introduces rigidity as there is no possibility of contracting the industry and therefore, reduces the advantages of an economic plan, a flexible excess profits tax, as suggested in the preceding pages, can effectively retain freedom of action to the entrepreneur within the orbit fixed by the plan.

The Corporation Tax

The corporation tax is the both a genus and a species. In the former aspect[33] it comprises a variety of specific levies including some discussed in this chapter. As a particular tax it has been tried in many countries such as U.S.A., Switzerland, Australia and Great Britain. Let us analyse the experience of any one of them. The British Corporation Profits Tax of 1920, for instance, was at one shilling in the £ on the profits of limited liability companies engaged in trade or similar transactions. "This tax," observed Austen Chamberlain, then Chancellor of the Exchequer,[34] "will run concurrently with the Excess Profits Duty until that duty is repealed. When a concern is liable to both taxes, any Excess Profits Duty payable will be treated as a working expense in arriving at the profits for the purpose of the new tax. Both the excess profits duty and the corporation tax will be deducted before the assessment of profits for income tax, and to

33. For an exhaustive analysis of the corporation tax *vide* E.R.A. Seligman: *Essays in Taxation* pp.142-315.

34. *The Economist* 24th April 1920. p. 855. The tax was abolished by Phillip Snowdon in 1924.

prevent the new tax constituting too severe a burden on the ordinary shareholder of existing concerns in which there are large issues of debentures and preference shares, where a considerable proportion of the profits has to be allocated to the payment of interest and fixed dividends thereon, we propose that in no case shall the duty exceed 2 shillings in the £ ".

Thus, the tax was levied on investment income of a particular variety, namely, on ordinary shareholders. It was regarded as different from and imposed in addition to the excess profits duty, which was abolished in the next year. And it was, like the excess profits duty, a flat levy.

The obvious defect of the corporation tax led soon to its repeal. It was found discriminatory without any special social objective, since it burdened a particular class of property owners, namely, the equity holders and exempted the debenture and preference holders as well as those having government stock and gilt-edged securities. It, thus, tended to damp risk-taking as there was no scope for rewarding differing risks. A natural consequence was, and would be, the diversion of enterprise and capital to safer investments. Further. since the tax was necessarily on joint-stock companies, it tended to encourage the growth of the less desirable forms of business organisation, namely, the untaxed partnership and single ownership. Finally, as it was flat-footed, it inflicted considerable hardship on small investors because of its regressive effects.

These limitations are true of the corporation tax even today. On the other hand, the excess profits tax, in the flexible form suggested by me, offers definite advantages in that it provides for risk, correlates normal profits with efficiency, applies to all forms of business and is progressive.

CHAPTER VII

The Tax in India.

GENESIS AND GROWTH

The Excess Profits Duty was first introduced in India in April 1919 by Act X of that year. India was the last of the countries during the period of the Great War to make use of the tax, as in other countries the duty was imposed during the war, Great Britian herself adopting it in 1915 while by the end of 1916 most of the western countries–belligerent and neutral–had introduced it.[1] It is difficult to explain why India opened her eyes only after the close of the war and when the rest of the world was contemplating the abolition of the duty. As Sir Jeremy Raisman admitted years later,[2] one of the main grounds of objection to the measure in 1919 was that it had come too late and that, consequently, the profits had already been made and to a large extent appropriated or dissipated before the tax-payer was able to realise that he would have to pay a large sum to government. A business critic of 1918 put this very strongly :[3] "To begin (the excess profits duty) after the war is over and to continue a year or perhaps two years is a fitting climax to a financial policy which would be ludicrous if it were not unsound and so dangerous."

The Tax of 1919

Unkind critics may ascribe this late introduction to many factors. It might be suggested that in those days most of the large businesses were British owned and consequently an early tax would have affected them most as the standard profits would have been lower and the life of the impost longer. Such a

1. *Supra* ch.1
2. *Legislative Assembly Debates* 6 February 1940 vol. I No. I. p. 90.
3. *The Capital* 6th December 1918 p. 1251

suggestion, though unfair, finds support in the fact that a business which was liable to pay Excess Profits Duty in the United Kingdom was exempted from the Indian tax[4] and any plea of reciprocity would be only an eye-wash. It is hard to believe that the delay was because there were no excessive profits in India or that no advantage was derived by private business during the war. If, in fact, any country benefitted, it must be one of those which were technically at war but which did not suffer the devastation, privations and controls of countries like Germany, France and Great Britain. The course of prices during 1913–21 [5] indicates that extra profits must have been made by businesses in those years. The delay could not also be because there was no financial necessity for the tax, for though our share of the burden was not as large as that of Great Britain, yet public expenditure increased. [6] It is most likely that the delay was the result of difficulties associated with the administration of the tax which demands a high degree of efficiency in the Board of Revenue and of the usual hesitation in the introduction of any progressive measure in our country.

Reaction to late Introduction

The reaction even to the late introduction of this tax was very strong in business circles. The proposals were considered[7] "unjust, arbitrary, unsound and inequitable", indicating "the stupidity and feebleness of the present government policy." On the one hand, [8] the

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4. Act X of 1919, Schedule I (A)
5. The index number of prices was.—

1913	100	1916	130	1919	193
1914	104	1917	138	1919	199
1915	106	1918	151	1921	165

6. The public expenditure was (in crores.)—

1913-14	124·3	1916-17	138·8	1919-20	221·1
1914-15	124·4	1917-18	156·8	1920-21	241·0
1915-16	128·4	1918-19	190·6	1921-22	221·9

7. *The Capital*: 20 December 1918, p. 1376
8. *Ibid* 6 December 1919, p. 1258

government was accused of ignorance of the principles of taxation and, on the other,[9] of drafting the bill "on a foundation of academic principles". neglecting practicalities. These criticisms are similar to the reactions in America in 1921 which led to the abolition of the tax in that country.[10] "The propaganda for repeal", observed an American economist in 1922, "has been so widespread, so prolonged and apparently so well financed and interested." He characterised the condemnation of the tax as unreasoning and at the behest of powerful interests with the use of almost unlimited propaganda.[11] As in the United States of America, the opposition came from vested interests e.g. jute and coal. The tax was claimed to hit worst the coal industry, and the following figures were adduced[12] to show that there could be no excess profits in coal since the industry had been commandeered during the war and prices fixed.

Dividends (per cent)

	1913	1914	1916	1917
16 Companies	460	436	261	233
Average per company	29	37	16	15

These figures are misleading since some of the companies even in the worst year, 1917, paid a very high dividend, e.g. Bengal 65%, Khas Jherria 40%, and New Central 30%. Thus, even in the coal industry and the worst year there was a large margin of taxable profit. The mistake of the Government was not that it levied the tax, but that it did not levy it earlier and administer it as long and as rigorously as other countries did.

Whatever the cause for delay it had undesirable effects, for it affected the calculation of the standard profits. Under section VI of the act of 1919 the

9. *Ibid* 20 December 1918, p. 1376
10. *A.E.R.* 1922 March, p. 106
11. *Ibid* 1924 September, p. 498
12. *The Capital:* 10 January 1919, p. 202

profits of 1913-14 and of the next three years which were essentially war years, were taken as the norm. This meant that abnormal profits traceable to the war constituted the norm and the excess was necessarily less than what it should have been. Such a treatment is not only unfair in principle but also involves financially a loss to the administration. However, the tax did not last long, for, though the last at the start of the race, India was almost the first to abolish the levy in the budget of 1920-21.

The Tax of 1940: For a second time the tax showed itself in 1940. The bill was introduced early in that year, referred to a Select Committee and reported upon in March of the same year, finally passing the legislature and receiving the assent of the Governor-General in April and coming into operation in September 1940. But the story of old was repeated. The United States had the tax from the early thirties; the United Kingdom introduced it as soon as the war began, though she had a similar tax in the National Defence Contribution and the Armaments Profits Duty much earlier; but India waited until 1940 to realise the need for such a levy. As in 1919 but to a very much larger extent this delay was unfair to the community and disadvantageous to the Treasury. For, the standard year should not be very remote from the chargeable accounting period and since prices and profits began to rise [13] in anticipation of hostilities, the standard normal profits contained a large dose of abnormal gains definitely traceable to the war. It is because of this that Great Britain had the National Defence Contribution and Armaments Profits Duty long before the Excess Profits Tax proper was introduced. As the Finance Member admitted,[14] while accepting the average of 1937-38 and 1938-39 as also a standard year, this option gave a large number of businesses " a level of what is generally regarded as

13. *Infra* Table 27

14. *Legislative Assembly Debates* 13th March 1940. vol II no 5. p. 1277.

high economic activity . . . which might involve a revenue loss of crores."

It is interesting to contrast the approach to the tax in Great Britain and U.S.A. and in India. The British approach was partly financial, partly ethical and also partly political.[15] The American attitude was definitely move *non-financial.* In his tax message of June 1935 President Roosevelt said "Our revenue laws have done little to prevent an unjust concentration of wealth and economic power."[16] In India the tax was essentially financial–a war profits tax–and was meant to be temporary. The Finance Membcr referred to the social justice basis but preferred to justify the tax on a narrower and more concrete footing.[17] In fact, the preamble of the Act terms the levy "A tax on excess profits arising out of certain businesses in the conditions prevailing during the present hostilities." It is interesting to observe how meticulously this fact was interpreted.

Its limited Objective

To indicate clearly that this new taxation was related to war conditions the Select Committee amended the date of the application of the tax from 1st April to 1st September 1939, because the war began in September. Such a change, however much technically satisfactory like Shylock's pound of flesh, overlooks that war conditions, especially rising prices and profits though not actual fighting, prevailed prior to September and countinued long after the military defeat of the enemy; so that abnormal profits traceable to war conditions do not arise and end only with the war. It is not fair to hold, as Sir Cowasji Jehangir did in his minute of dissent to the report of the Select Committee [18] that the Government would

15. *Infra* ch. VIII
16. *A.E.R.* 1935 p. 673 Also *vide* the criticism of the Revenue Act 1935 by the Senate Finance committee minority, see ch IX
17. *Vide Legislative Assembly Debates* 6th February 1940 Vol. I No. 1 p. 88
18. *Ibid* 9 th February 1940 Vol. 1 No. 4 pp. 245 and ff.

not only share in the profits resulting from the war but also in normal profits and in normal increase of profits which every well-managed business hopes to make. The course of profits indicates that war conditions were already having their beneficial effects on some businesses.

TABLE XXVII [19]

Index numbers of Industrial Profits (India 1928-41)

(Base 1928 = 100)

	Jute.	Tea.	Coal.	Sugar.	Iron & Steel.	Paper.	Cotton.	All Industries.
1928	100·0	100·0	100·0	100·0	100·0	100·0	100·0	100·0
1929	85·6	59·6	98·4	79·6	18·6	93·2	91·1	78·0
1930	37·9	14·9	122·1	93·6	70·6	91·3	37·8	47·1
1931	8·7	19·8	91·2	144·4	78·0	86·6	52·5	27·8
1932	12·6	-1·1	75·0	253·9	66·2	92·4	82·8	34·6
1933	19·8	93·9	60·3	254·2	90·3	110·8	33·9	44·2
1934	34·4	50·2	59·7	194·2	169·2	108·1	90·1	62·6
1935	36.8	63·5	63·8	157·7	192·9	136·4	89·0	69·2
1936	25·9	70·8	62·5	247·0	179·0	157·4	98·8	63·1
1937	11·1	108·4	71·8	122·3	211·6	182·8	138·2	61·1
1938	-9·8	73·9	142·4	157·7	316·7	172·1	208·3	68·1
1939	13·6	96·2	139·1	179·4	289·5	151·8	154·6	72·4
1940	48·9	95·5	140·2	186·8	300·8	342·0	217·1	99·6
1941	46·6	139·9	115·0	248·3	387·4	419·5	533·2	137·8

TABLE XXVIII [20]

Industrial Profits (India 1935-38)

(Base ; 1928 = 100)

Year.	All Industries.	Iron & Steel.	Sugar.	Paper.	Cotton	Coal	Tea	Jute
1935	69	193	148	136	89	64	64	40
1936	63	179	247	157	99	193	71	26
1937	61	209	122	183	138	158	108	11
1938	71	311	158	191	253	136	...	-8

19. Data from the *Statistical Summary* of the Economic Adviser, Government of India.

20. Sir Ziauddin Ahmed gave the these figures in his minute of dissent in the Select Committee on the E.P.T. Bill

The correct solution for any such meticulous interpretation of abnormal conditions is, as suggested by me earlier,[21] the universal adoption of the statutory percentage and the conversion of the tax into a true excess or abnormal profits tax and not a temporary profits tax.

The main ground for its introduction according to the Finance Member [22] was the additional expenditure resulting from the war and the necessity for adequate revenue to meet that expenditure. Sir Jeremy Raisman, therefore, would turn first to those classes of the community which found themselves not worse off as a result of that same emergency but actually a good deal better off." It is almost pathetic to read Sir Jeremy repeating that "the principle of this bill is not the taxation of the profits which cannot be demonstrated to be due to the war; it is taxation of excess profits arising in war times and in war conditions, because it is based on a principle of *priority of taxation* viz: that the cost of the additional defence measures should be borne in the first instance by those who in the conditions of war find themselves not worse off but better off." Thus, financial necessity alone gave birth to the tax.

It is, indeed, strange that in a country like India, where inequalities between the few rich and the many poor are so marked and where excessive profits and "profiteering" are more common than in the West the state should have hesitated to accept the ethical basis of the tax.

The tax continued for six years undergoing during that period some modifications, a large number of which followed amendments in the United kingdom whose example had been copied, sometimes too slavishly, in the structure of the Indian tax. In 1941, hardly a year after its introduction, the tax rate was increased from 50 per cent to 66 2/3 per cent of the excess. An excess

21. *Supra*. Ch. IV.

22. *Legislative Assembly Debates* 6th February 1940. Vol. I No. 1. p. 88.

profits double taxation relief agreement between the United Kingdom and India was entered into, while the standard profits for new industries was fixed at 12 per cent of employed capital. In October of the same year the Excess Profits Tax Second Amendment Act introduced a few important changes such as the inclusion of borrowed money in computing capital, provision for wasting assets, prevention of wasteful expenditure and fictitious or artificial transactions to evade the tax, and rules regarding profits arising in Indian States. In March 1942 the system of compulsory deposits was introduced—the amount to be deposited being fixed, at first, at 1/5th of the tax rate but later in 1944 being changed to 17/64–ths, the government undertaking to return after the War 10 per cent of the tax paid; and the double taxation relief provisions were extended to Ceylon and Aden. Just before the end of the War, in 1945, special increased depreciation allowances in certain cases were introduced and many loopholes for evasion were closed. Finally, in 1946 the excess profits tax was repealed as from April of that year after being characterised by Sir Archibald Rowlands, the Finance Member, in his farewell budget speech: "By all canons of taxation it is a thoroughly bad tax. It is rough and ready in its operation; it is unfair in its incidence and beyond a certain point it is a direct inducement to inefficiency." The abolition of the tax was ill-advised and ill-timed. The war, no doubt, was over but not the war conditions. High prices have continued and profits have not declined. The injustice of the repeal of the tax appears to have been realised by the first Indian Finance minister and in the budget of 1947 the Business Profits Tax closely resembling the excess profits tax was imposed.

STRUCTURE OF THE TAX

The excess profits tax of 1919 applied to "every business carried on in British India by any person or carried on in any place in India by a person ordi-

narily resident in British India," with the exception of certain specified kinds of businesses.[23] The 1919 Act followed the British Law of 1915 and was comprehensive as well as being over a wide area.

Area of Application.

But the tax of 1940 was not only restricted in application but also more complicated, partly on account of altered circumstances such as the separation of Burma and partly because of changes introduced by the Income Tax (Amendment) Act of 1939. The tax applied to the whole of British India, excluding Burma; and Indian States, being autonomous in certain respects, were also outside the scope of the levy. Even in British India, taxable profits were brought under two heads-according to the nature of the business and according to the person carrying it on. Thus, (1) where the profits of the whole of the business accrued or arose in British India, the tax applied whoever carried on the business—an ordinary resident, person not ordinarily rcsident or non-resident. (2) Where only a part of the gains accrued or arose in India, an ordinary resident was completely liable, while one not ordinarily resident was taxable fully if the business was controlled in India and only partially, in other cases. Non-residents paid only on the profits arising in British India. "In all cases," observed J. F. Sheehy in introducing the bill in the Indian Upper House,[24] "the tax is liable on the arising basis and not on the remittance basis, so that if a resident or non-resident receives in British India foreign profits which are not taxable on the arising basis, they will not be liable to the excess profits tax although they will be liable to income tax."

These provisions may be further analysed in view of their consequences during 1940-46 and, especially, of the possible effects in the new divided India. One kind of difficulty was felt in the case of Burma. Till

23. Schedule 1.

24. *Council of State Debates*, 26th March 1940. Vol, I. No. 10. P. 308.

1937 that country was a part of India so that some of the standard years, for example, 1936, would include Burma profits also, while they would be excluded in the chargeable years. It, therefore, became necessary specially to provide for the exclusion from standard years of Burma profits unless the business included them in the assesable years also.[25] The complication of determining such profits and excluding or including them could easily have been and can be avoided by the adoption of the Capital Standard which is independent of pre-tax years.

A more important consequence was the exclusion of Indian States[26] which are, economically at least, a part af India. A consequence of such exclusion was the migration of business–wherever possible, physically and wherever not, the technical control only—to the untaxed areas e.g., Baroda. In 1940–46 a few old and established concerns were so shifted and many new ones floated in the states. Such a consequence of taxation was, until recently, a familiar feature in the United States, but with regard to the excess profits tax, India had no parallel. No doubt a number of Indian States, partly in their own interests and partly because of other influences, introduced the profits tax but neither at the same time nor at the same rate as in British India.[27] The repurcussions of such inter-State migration of industry, would be considerable, especially in the future economic development of the country and would undermine any national economic plan.

Three remedies may be suggested. First,, if the States continue to be autonomous in taxation, a bilateral tax agreement whereby uniformity in the

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25. S 6 (5)

26. Such profits were completely excluded by clause 3 of the Excess Profits Tax (Second Amendment, Act of 1941).

27. For example Mysore 1945 at 60%
Travancore Sept. 1944.
Cooch Behar. April 1943 at 25% till 1945, 50% after.
Bhavnagar August 1943.

rate and structure of the tax is maintained in British India and the States. Second, where such a treaty is not possible, taxation of profits on the basis of their orgin irrespective of the location of control so that all profits traceable to British India could be reached. Perhaps the most equitable solution is administrative centralisation i. e., central control and collection of the tax but division of the proceeds, (as in the case of the income tax between the Provinces and the Central Government or of other taxes as in Pre-Nazi Germany), largely in harmony with the doctrine of economic interest. This solution is the best because the tax is as much an instrument of economic planning as of revenue and any plan must be centralised in conception and direction.

The third questionable aspect of the 1940 tax was the treatment of foreign profits. In the case of non-residents, only profits arising or deemed to arise in British India were taxable. In all cases the tax was leviable on the arising basis and not on the remittance basis, so that if anybody received in British India foreign profits which were not taxable on the arising basis, they were not liable to the excess profits tax, *although they were liable to the income tax*. Thus, the scope of the former was definitely narrower than that of the latter.

It is difficult to justify this difference between the two taxes. If both the arising and remittance bases are good and just for the income tax, they should be good and just for the profits tax also. A state has the moral right and an economic justification for both the bases. The only objection may be that the tax-payer would be squeezed out if two or more countries adopt both the bases but this would hold good with regard to the income tax as well. The remedy lies, not in giving up one of the bases, but in tax treaties and reliefs wherever the burden is unfair. Otherewise, India would be sacrificing her tax revenue for a foreign country's benefit.[28]

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28. Compare the discriminatory treatment in the U.S.A. Acts of 194[illegible]

SCOPE

As in other countries so in India both in 1919 and in 1940 the tax was essentially a business tax, applicable to any trade, commerce or manufacture.[29] The 1919 Act excluded from its operation certain businesses, for instance, any business the income from which was agricultural ; offices or employments ; professions depending on personal qualities and not on capital, except commission business ; any business liable to pay the excess profits duty in the United Kingdom ; and any business whose profits did not exceed Rs. 30,000. The duty could be assessed on any person for she time being owning or carrying on the business whether as an agent or otherwise.[30]

The Act of 1919

One or two of these exclusions are open to question. It is unfair to exclude businesses liable to tax elsewhere, for, in the case of India and especially in 1919, most of the assesable businesses such as railways, managing agencies, plantations, jute and coal had their control located in Great Britain though the place of operation and the origin of profits were in India. Their exemption would sacrifice Indian interests to those of the the British exchequer, since there are no businesses carried on in Great Britain but controlled in India and thus available for reciprocal treatment. Further, in those days when businesses were few and far between, the minimum profit level of Rs. 30,000, obviously introduced for reasons of administrative convenience, must be regarded as too high, and this point is elaborated below in connection with the 1940 tax.

The 1940 Act also followed closely the principles of the 1919 duty and of the English Act of 1939.[31]

29. Section 2.

30. Schedule 1.

31. Even the wording of the Indian Act is largely taken from the English Act of 1939. Only important differences and similarities are pointed out below.

The 1940 Tax

The tax applied to any trade, commerce or manufacture or any profession or vocation except where the profession or vocation depended wholly or mainly on personal qualifications or unless such profession consisted wholly or mainly in the making of contract on behalf of other persons.[32]

Business was defined to include certain professions also, such as those of a stock-broker and the holding of investment in some cases. If other professions were carried on by incorporated bodies such as a company, and not by individuals, the gains were taxable because of the inapplicability of the exemption test, namely, personal qualifications as a necessary ingredient of a profession.

Life insurance business, but not other forms of insurance, was completely exempted,—this concession was put into the bill by the Select Committee,—on the grounds that it was difficult to assign to a particular year the profits which, in such business, are usually determined by a triennial or quinquennial valuation and not annually; that the quinquennium would include both the standard period and the chargeable accounting period; and that this type of business would not earn abnormal profits as a consequence of the war.[33]

Such exemption was not given in the British tax of 1939. In fact, this question was discussed in detail in Great Britain in connection with the levy during the First World War. Only *mutual life* insurance companies, but not life insurance in general, were exempted from the E P D of those days, although the Inland Revenue Department felt that the profits of life insurance concerns were not high enough to make them taxable.[34] In U.S.A. also these businesses

32. Section 2.

33. Finance Member's speech. *Legislative Assembly Debates 13th March* 1940, vol. ii no. 5 p. 1276.

34. *Report on the Taxation of Excess Profits in Great Britain. A.E.R.* 1921. Supplement, appendix D.

were taxable under the 1941 law[35] though certain deductions were allowed under the assessable net income. Even some varieties of mutual insurance companies did not escape the American tax.[36]

Not only did other advanced countries follow a course different from ours, but in principle also, the Indian attitude to life insurance concerns is unjustifiable. As these businesses are liable to income taxation, there is no ground in equity why they should escape the profits tax- From the administrative point of view, the practice of quinquennial valuation is only a matter of convenience. Annual valuation of assets is not only possible but is common in established companies in Great Britain. Primarily, it is the uncertainty of being uniformly successful every year and the possible repurcussions of a comparatively unsuccessful year on the standing of the concern that underlies the practice of trienniel or quinquenniel valuations. The cost of annual valuations, too, does not seem to be prohibitive. Further, the plea of low profits is not also tenable because, first, the profits of some Indian insurance companies have been definitely high, the dividends often exceeding 60 per cent. per annum;[37] even if a large number of life concerns earn profits below the taxable limit, they would be on a level with many unlucky concerns in other taxable businesses. The low profits of a few or even many should not exempt the whole group.

Probably it is desirable to exclude from taxable profits the amount distributed as bonuses to the insured but the profits enjoyed by the shareholders of the insurance company cannot claim any exemption. If these are taxed the gains may possibly be distributed more generously to the beneficiaries in order to evade the tax, and such a consequence appears welcome, though the state may thereby lose a part of its revenue.

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35. Excess Profits Tax Regulation 112 of 1941 Section 711 (4)
36. *Ibid* Section 710.
37. *Supra* 104; also Table XVI p. 117.

While the Finance Member unfairly exempted life insurance concerns, he rightly resisted the attempt to exclude banks also.[38] Concession for banks was claimed on the grounds that they were similar to insurance business ; that the War was likely to damage instead of benefit them ; and that banking was essential for industrial development. I have pointed out above why life insurance itself should not be exempted. The effect of the War on banking is difficult to estimate, for, as the Chairman of LLoyds' Bank Ltd. explained to the shareholders,[39] earned published profits are no dependable guide either to the true or to the taxable profits. In Great Britain banks were liable to the excess profits tax but they largely avoided paymet because, in the words of the LLoyds Bank's chairman,[40] "The profit of the standard year for EPT was not unfavourable." So it was a defective normal rate that enabled the banks to escape the tax. The practice of hidden reserves and dividend equalisation funds is more common among banks than among other businesses. Even the published statements of these institutions sufficiently indicate how high the profits are,[41] and if businesses earning lower profits are taxable, it is unfair to exempt banks. The plea of the importance of banks in industrial development is also untenable because the existing system of banking in India has done very little and is unsuited to do very much towards industrial advance.[42] Finally, a tax on excess banking profits may conceivably help industries, for, in order to evade payment, the banks may either increase the deposit rate or reduce the loan rate, so that their profit

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38. *Legislative Assembly Debates 15th March* 1940, Vol. ii No. 7 P. 1411

39. *The Economist* 23rd January 1943. p. 112.

40. *Ibid.* Also vide the explanation offered by Sir R.N. Barclay, chairman of the District Bank, Ltd. in his address to the 113th Annual meeting 29th December 1942. (*The Economist* 23rd January 1944, p. 125.)

41. *Supra* pp. 104 and 177.

42. P. S. Lokanathan*: Industrial Organisation in India,* P P. 140 and ff.

margin would be less. And such a reduction in loan rate would encourage industrial borrowing.

In 1940 there was no specific exemption of agriculture as in the 1919 Act. The distinction between the taxable business and exempted professions was not clearly defined but was left for individual decisions of courts of law. Unlike in the United Kingdom, local authorities were exempted so that public undertakings and services as well as businesses carried on by local bodies were not liable to the excess profits tax though they were liable to the incometax. In this respect the Indian Act was not only fairer than but was far in advance of, that of the United Kingdom, for, as pointed out elsewhere,[43] there is no social significance or financial benefit in levying the tax on limbs of the State.

The Initial Exemption and its inequity

Further, in order to reduce the administrative inconvenience and cost of handling numerous small concerns ,the minimum standard profits which would make a business assessable were fixed at Rs. 36,000 per annum, those earning less not being liable to the tax. This made the tax applicable to about 2,500 businesses. The minmum proposed in the original bill was Rs. 20,000, according to which the tax would apply to 5,000 cases. It was raised in the Select Committee to Rs. 30,000. which was regarded by the Government as a very important alteration. The amount was further increased in the Assembly to Rs. 36,000. The Finance Member accepted this modification, [44] " because I feel that something more than the bill at present provides should be done for partnerships.....The position in the United Kingdom is that there is a higher exemption limit for partnerships and I think that is the most suitable way of dealing with that type to hardship. I also am attracted by this form of solution because it

43. *Supra* p 136

44. *Legislative Assembly Debates* : 19th March 1940, vol II No. 8 P. 1539

reduces the administrative difficulties with which we shall be faced."

It is really difficult to appreciate Sir Jeremy's reasons or to justify the high initial minimum of exemption. In Great Britain the 1939 Act fixed it at £ 1,000 and in the case of a partnership or a company the directors whereof had a controlling interest, such a greater sum not exceeding £3,000, as was arrived at by allowing £750 for each working proprietor in a trade or business.[45] This means that the general exemption was £1,000, and only partnerships got a *maximum* of £3,000, but the actual minimum that any one concern could get would depend upon the number of working proprietors it had. This may be compared with the general exemption limit of Rs. 36,000, in India, irrespective of the type of ownership. Not only did a large number of corporations unfairly benefit by this, not only did the State lose the revenue thereof, but no discrimination was made in favour of partnerships which fact alone was the basis of the distinction in the United Kingdom. Further, in a country where the probable number of assessable firms was large, where the rate of the tax was high and where large businesses were more in evidence, the minimum was fixed at £ 1,000, and obviously the administrative difficulty of dealing with a large number of assessees was not felt.

Similarly under the Canadian Act of 1940 [46] a taxpayer with an annual profit of 5000 dollars or less, or in the case of a corporation or joint stock Company, where the chargeable period was less than 12 months, profits proportionate to the number of days in terms of 5000 dollars for the complete year before providing for any payment to shareholders by way of salary, interest, dividend or otherwise was exempted. In the United States also [47] the specific general exemption

45. Finance Act (No 2) of 1939 - Section 13.

46. § 2 (1 Proviso. § 7 c and 7 a. (Act of 1941, clause 26, § 9.)

47. Regulation 112, Sub chapter E of Chapter 2 of the Internal Revenue Code as amended in 1940 and later. Section 710 (b) 1.

was 5000 dollars and in the case of a mutual insurance company (other than life or marine) which was an inter-insurer or reciprocal under-writer the specific exemption was 40000 dollars.

In India, where the number of large concerns was small, the rate of profits high and the need for revenue not less urgent, the minimum should not be even at the British level but perhaps lower. As the Finance Member himself admitted,[44] even at Rs. 20,000 only about 5,000 businesses would have come under review, and if this number is regarded as leading to administrative difficulties, then the standard of administrative efficiency must be very low indeed. It was, therefore, an unfair concession to have increased th minimum beyond 20,000. The right course appears to have been to retain the original Rs. 20,000 for corporations, giving an additional Rs. 10,000 to partnerships at so much per partner, and in all individual cases permitting an appeal to the Board of Referees or to some other authority.

DETERMINATION OF THE STANDARD PROFITS

As in most other parts of the world, the major method of determining normal profits in India was the Income or profits Standard. In preferring the latter in Great Britain, the British Chancellor regarded the per centage standard as in practice productive of the most frightful complications and the Income Standard as much better and more practical. India adopted a similar attitude, though both the standards were found in 1919[49] and 1940.[50]

The Profits Standard

The Income Standard operated in the majority of cases, especially where businesses were started before March 1936. Four alternative periods for computing standard profits were given to the assessee to choose

48. *Legislative Assembly Debates* 6th February 1919. Vol i No 1 P 93.

49. Excess Profits Duty Act. 1940 S. 6.

50. Excess Profits Tax Act. 1940 S. 6.

from–1935-36 or 1936-37, or 1935-36 and 1936-37; or 1936-37 and 1937-38; or 1937-38 and 1938-39.[51] In no case could the minimum length of the standard period be less than 9 months. In addition to these alternative years, the Board or Referees could allow a higher amount, if necessary, for instance, in the case of undertakings in the process of development or those suffering from industrial depression.

The last of these alternative periods was added in the Select Committee to afford some advantage to businesses which earned good profits in 1937-39. The mistake of such a concession may now be followed. 1935-38 were considered by some as years of severe depression for Indian industry. From 1931, observed Sir Cowasji Jehangir,[52] "there was a gradual increase during the next two years and 1934 saw definite improvement, and we had only reached 70·6 in 1938 which Government now desire to exclude. The first sign of a crash was in 1929 and the index figure is 78. 1938 is therefore even lower than 1929." He suggested that 1938-39 was deliberately omitted because they were not found in the British Act, and that in Great Britain there were war profits in 1938-39 because of preparations for war, but conditions in India were different. Commenting on the inclusion of 1937-38 and 1938-39 in the standard years, Sir Jeremy Raisman admitted[53] that the inclusion of "this option extended to a large number of businesses the facility to adopt a level of what generally is regarded as high economic activity as the basis in determining the standard profits. It is a change the importance of which can hardly be exaggerated and the effect on the incidence of this tax is very great indeed." He added "that, although the advantage to certain concerns which has resulted in this important modification is extremely substantial, nevertheless it

51. The Indian Excess Profits Tax Act, 1940, Section 6.

52. *Minute of dissent, Clause 6 (2) Report of the Select Committee.*

53. *Ibid.*

is counterbalanced by a great improvement in equitable incidence of this measure." The Finance Member originally wanted to tax the profits of "shadow war", but as a part of industrial activity was presumed to be unaffected by the quasi-war conditions, he accepted 1938 in order to eliminate cases of hardship.

Foreign parallels may be analysed here. Under the British 1939 Act two broad divisions were made. (1) In the case of businesses started after July 1936 the statutory percentage of 8 per cent applied to corporations, 10 per cent for decrease of capital. (2) The income or profits standard applied in other cases as below : (a) started prior to 1936—full profits of one year or half of two years; if capital in any chargeable year was increased or decreased then the statutory percentage on increase or decrease was allowed (b) started prior to 1935 the profits of one of the following at the assessee's option—1935 ; 1936 ; half of 1935 and 1937 or half of 1936 and 1937. (c) started between January and December 1935 . . . profits of 1935 or half of 1935 and 1936 ; (d) started in January-June 1936 . . . profits of 12 months upto June 1937; (e) after July 1936, Statutory Percentage on the average capital. If such a profits standard was considered unsatisfactory because of low or no profits, the commissioner could allow enough to declare 6 per cent on ordinary paid up shares and at the fixed rate on others. The justice of the British practice is obvious. No concern was allowed 1938 or later as a standard because the war was declared in September 1939 and disturbed conditions prevailed since 1938. As the choice of standard years was limited to 1935-1937 and not later, no profits savouring of war conditions could be included in the normal level. "In the United Kingdom," the Indian Finance Member confessed,[54] "the standard period related to periods of lesser prosperity and was lesser in number. The effect of the more

54. *Legislative Assembly Debates* 4th March 1941 Vol. II., No. 3., P. 998.

numerous and more recent options which are given in India is very serious indeed on the yield of the tax." The significance of this becomes marked when it is remembered that the British level of profits had been definitely lower than in India and that already taxes like the N.D.C. were operating. Moreover, the choice of standard years was not open to the assessees, as in India. While in the latter country a business could choose any level between 1935 and 1939, it was in Great Britain limited to specific alternatives.

In Canada, again, where the rate of the excess *profits tax was 100 per cent*, the standard years were 1936-1939.[55] The same base years were allowed in U.S.A.[56] where, however, the variety of taxes on business was greater, the rate of income and other taxes higher and the excess profits tax itself was in existence from 1934.[57]

The Indian Finance Member was even accused of " smuggling into the taxable excess profits normal gains which had nothing to do with the war and which indeed represented an artificial inflated figure." Leaving aside the fundamental question as to whether war profits alone should be taxed or all abnormal profits found in plenty in this country [58] it may be noted here that all the extra profits made in the war period were not inflated but were largely real profits. As I have pointed out elsewhere,[59] the net profits index outstripped the price index indicating that while inflationary prices have contributed their share of increased profits, there has been real improvement in earnings resulting largely from the increased demand for the supply :

55. S. 2 (h)

56. S 713 of the 1941 Act.

57. *Supra* p. 9.

58. *Supra* pp. 139 and ff.

59. M. H. Gopal: Industrial Profits since 1939 (*The Eastern Economist*, 12th May 1944 p. 730. See also *Ibid* Statement. I.)

TABLE XXIX

Net Profits of some enterprises, and prices (India 1939-43,)

BASE : 1939 = 100.

	1939	1940	1941	1942	1943
Jute	100	519	617	896	926
Cotton	100	73	205	313	645
Tea	100	118	214	252	392
Sugar	100	143	122	160	218
Coal	100	88	107	95	124
Engineering	100	115	180	36	225
Miscellaneous	100	104	326	394	401
All kinds	100	127	282	259	327
General price level	**100**	**116**	**129**	**158**	**217**

And it was most unfair to the exchequer and the community for Sir Jeremy to accept 1938 as a standard year, for, not only were normal profits not included in the taxable excess, but the standard profits themselves in many industries, and certainly in many assessable concerns, included 'shadow war' profits.

The inequity of the standard years was more pronounced in the 1919 tax. According to the Excess Profits Duty Act of 1919, the taxpayer could not only choose between the Capital Standard and the Income Standard but he could choose any of the following norms under the Income Standard :[60]

(1) Half the profits of 1913 and 1914 as assessed for income tax *plus* half the interest received on securities forming part of the assets of the business.

(2) One-quarter of the aggregate of the profits of 1913 and 1914, and of any two of the three years, namely, 1915, 1910 and 1917, *plus* one-fourth of the interest on securities in the same four years.

60. S 6 (1).

Additions to or deductions from capital in the accounting period as compared to the standard years were allowed proportionate changes in the standard profits calculated as above.

These standard years may be compared with those of Britain—1912—15, of U.S.A.—1911-13 or of Canada. Thus, the abnormal profits of at least three war years were included in the Indian standard period, necessarily reducing the degree of excess liable to taxation. Vested interests, however, regarded this as " a reasonably profitable period." In view of the extremely late imposition and short life of the tax at that time, the inequity of the standard years may not have been material and of much consequence.

Unless the tax is levied, as the other countries, at the beginning of the emergency, it is a mistake to regard the pre-tax years as the norm. The comparison should not be between the chargeable and pre-tax years but between the chargeable and the pre-emergency years, irrespective of how late after the emergency the tax is levied. Thus, India, though she imposed the tax in 1919, should have taken 1912-14 as the standard. A universal Capital Standard would obviate all such complications.

The Statutory Percentage

In 1919 there was not much complication in the " statutory percentage " adopted, in fact, even that phrase was not used. It was a general allowance of 10 per cent, or " not less then 10 per cent as may be prescribed," on invested capital at the end of the accounting period and was an alternative allowed to *all assessees.* Although the English Act of 1915 was copied in many other respects, it was not followed in this case. No discrimination was introduced in the statutory percentage between corporate and non-corporate bodies or where the percentage was optional or inevitable as in the case of concerns with insufficient pre-tax years. The rate allowed in the United Kingdom at that time varied between 6 and 11 per cent.

The Indian rate was definitely higher and was perhaps justified because of the different conjunctures regarding the rates of interests, the paucity of enterprise, etc. But to some extent simplicity and uniformity were achieved at the cost of equity, since non-corporate businesses deserve more favourable treatment because of greater risks. Moreover, while the basic rate was fixed at 10 per cent the Board of Referees could,[61] in individual cases, grant a higher rate if necessary. This arrangement naturally introduced greater equity between industries and involved less of financial loss to the state than any general high exemption would have meant.

The Capital Standard was of more limited application in the 1940 levy. It was not a general option to the profits standard. It was allowed in three sets of circumstances :[62] (1) in the case of of new concerns, for the simple reason that there was not sufficient actual experience of their normal income on which to go ; (2) in the case of those started after March 1936 which, again, for insufficiency of standard years, had the option of choosing the profits standard or the statutory percentage ; (3) in the case of decrease of capital in 'old' businesses i.e. those started prior to 1936 March to which, otherwise, the standard did not apply ordinarily.

There was considerable discussion in the Select Committee about extending the capital standard to old firms also, and an amendment was moved unsuccessfully by A.C. Dutta in the Legislative Assembly to give the option as was done in 1919.[63] The Finance Member opposed it on two grounds:[64] *On grounds of equity*, it was unsustainable to allow 8 per cent–this was the statutory percentage in some cases–to firms whose normal profits in the pre-tax or standard years

61. In Great Britain the Board of Referees granted extra percentage, in some cases, as much as 29%

62. Section 2. (21)

63. *Legislative Assembley Debates* 13th March, 1940, Vol. II, No. 5.

64. *Ibid.*

were less and to deem them as not having made any excess profits until they make over 8 per cent during the war period. *On grounds of administration*, the calculation of the invested capital would have to be made in a large number of cases and would occasion considerable administrative difficulty in working out percentages on the original capital invested long ago.

Its Limited Scope: The limited application of the statutory percentage—only in inevitable cases—was obviously based upon the conviction that it was an unavoidable evil and the Profits Standard was better. As the Chancellor of the Exchequer put it in 1939, the Capital Standard "did in practice produce the most frightful complications . . . Relying on a pre-war standard based on profits is much better and more practicable than the old system." The untenability of this view and the essential fairness of the Capital Standard have been discussed elsewhere.[65] The effect of relegating this standard to a subsidiary position is evident from the following case.[66] Among coal companies, *Bengal* was not as profitable as *Bengal–Nagpur*, the average dividend of the former for 22 years (1918–1939) being 33½ per cent and the latter 48½. But, according to the standard years under the 1940 tax, i.e. 1935–39, the best standard profits for *Bengal* were in 1938-39 giving an average of 18 per cent and for *Bengal-Nagpur* 1936-37 with an average of 12½ per cent. Obviously, the two concerns would have to choose these two standard profits with the result that *Bengal-Nagpur*, which had *an advantage of 50 per cent* extra profits, now suffers a *disadvantage of* 50 per cent compared to *Bengal*—certainly a deplorable case of inequity. On the other hand, if a statutory percentage of 8 or 10 per cent is given, the injustice will be greatly reduced. After all, as argued elsewhere[67] the normality of returns should

65. *Supra* pp. 147-49.

66. *The Capital*, 10 January, 1919, p. 202

67. *Supra* ch IV

not be based upon a perpetuation of existing inequalities and monopolistic advantages, but on grounds of reasonable returns from the business and social welfare points of view.

The rates allowed

However, the statutory rate varied between 6 and 12 per cent on the capital invested. A difference was made on the basis of ownership and according to the time of start. According to ownership,[68] the statutory percentage was 8 per annum for a business started prior to 1st July 1938 by a corporate body other than a company the directors whereof had a controlling interest therein; if the business was carried on by a partnership of which one or more of the partners was a corporate body, 8 per cent was allowed on the capital representing the share of such a corporate body and 10 per cent on the remainder of the capital. In the case of decrease of capital the statutory percentage in all cases was 6 per cent These provisions were similar to the 1939 British practice[69] and the American tradition of 1941.[70] One important American feature was the differential treatment of domestic and foreign corporations. Domestic corporations enjoyed 95% of average base period net income plus 8 per cent on capital deductions, whereas foreign corporations were allowed only 95% of the net income and not the addition or deduction for capital changes[71]–a feature which may be followed with advantage in India. In Canada the same rate of 7½ per cent was allowed on both increase and decrease of capital if accompanied by an equivalent alteration in capital stock.[72]

The other distinction was based on the *time of*

68. Section 2 (21)

69. United Kingdom Finance Act 1939, § 13 (6)

70. U.S.A. Regulation 113 §. 713.

71. Section 713.

72. The Canadian Excess Profits Tax Act, 1940 § 4 (i) and (ii)

commencing the business.[73] Those started after July 1938 were allowed in India 10, 12 and 8 per cent instead of 8, 10 and 6 as stated above. Obviously this differential treatment is attributable to two reasons (1) the need to encourage the floating of new businesses in an emergency and (2) to compensate for the increasing rates of interest, higher wages and greater risks. While the special treatment of new concerns can be appreciated, certain modifications on the American and Canadian models could have been adopted. As in Canada, increases in capital should have been included for extra allowance. Morever, as the higher percentages apply to new firms, there was no provision for expansion of old ones. In view of the experience of the old firms, it would be more advantageous to encourage them to invest more capital. Moreover, the distinction between increases and decreases of capital based on British experience of 1917 ought not to have been made, since it would unnecessarily place a premium on over-capitalisation as in the United States of America.[74] Finally, a limit must be set to the maximum new capital allowed; otherwise, all available funds would be diverted to industry, irrespective of the need for profitable investment, since a public loan would carry a far lower rate of interest than tha t allowed as statutory percentage on new capital.

The American tax of 1941 had a very useful expedient. The profits credit based on invested capital varied with the amount of capital and the statutory per centage differed as below:[75]

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73. The Indian Excess Profit Tax Act. of 1940. Section 2 (21)
74. Section 718 E
75. Section 714.

Invested Capital.	Credit Allowed.
1. Not over 5 millions.	8 per cent on capital.
2. Between 5 and 10 millions.	4,00,000 plus 7 per cent. on excess of captial over 5 millions,
3. do. 10 and 200 ,,	17,50,000 plus 6 per cent. on excess over 10 millions.
4. Over 200 ,,	£1,21,50,000 plus 5 per cent. on ex ces over 200 millions.

The rates were modified in 1942 as under.

1. Not over 5 millions.	8 per cent.
2. Between 5 and 10 millions.	4,00,000 plus 6 per cent on excess over 5 millions.
3. Over 10 ,,	7,00,000 plus 5 per cent. on excess over 10 millions.

Four interesting features stand out. First, the lowness of return allowed, the rate ranging from 8 to 5 per cent. Secondly, the association of a fixed amount with a varying rate on excess of capital above a sum. Thirdly, the decreasing percentage with increase of capital so that, it was the comparatively smaller businesses that were more generously treated. Finally, the realisation in 1944 that the return to larger businesses must be cut down and should not exceed 6 per cent. Very few businesses in India empoly such vast capital as in America, nor is the Trust form of business common. And the principle of a fixed amount plus a low percentage on excess could very usefully be considered as it will prevent unhealthy industrial combinations and reduce the necessity for anti—Trust laws.

This basis of distinction could be converted into a useful lever for industrial expansion under a permanent tax. An increased percentage may be allowed, as protective duties and subsidies are, for an initial period which might even vary with industries.

The second distinction noted above was added in the Select Committee. The rate of 6 per cent was regarded as a copy of the British rate unsuited to India, because " many preference shares in Indian

companies with first class security behind them are entitled to 6, 7 and 8 per cent though it is perfectly true that many of these shares stand to-day well above par." Consequently, said A. Aikman,[76] a higher rate should be allowed in the case of ordinary share capital which from its very nature bears a greater risk. This sentiment was repeated by Sir H.P. Mody[77] who said that while the capital of the business may be small, the block account built up over a period of years may be many times that figure and that, therefore, if only 6 per cent is allowed on the nominal capital, then no relief is afforded to the assessee who has been hit by abnormal circumstances during the standard period.

COMPUTATION OF INVESTED CAPITAL.

Wherever the Capital Standard is employed the amount of invested capital must necessarily be computed in order to allow the normal profits. In the 1919 Indian Act invested capital played an important part, first, since the statutory percentage was a general alternative to the Income Standard and secondly, as the basis for adding to or subtracting from the standard profits on account of changes in employed capital. In the tax of 1940 the statutory percentage was of more limited application and so computation of capital was not of great importance. It was utilised in the case of businesses started after March 1936 which chose the Capital Standard and in the case of increase or decrease of capital in the chargeable accounting period.

The Act of 1919 contained many of the essentials discribed below but very briefly stated.[78] The 1940 tax generally closely followed the 1939 British example. The fundamental concept in India was 'Proprietor's Capital' and so a restricted view of what constituted capital was taken. There was little to suggest that

76. *Legislative Assembly Debates*, 6th February 1940 Vol I No. I p. 100.

77. *Ibid* p. 104.

78 Schedule II.

capital must be productively employed during the chargeable accounting period. A possible consequence of such indefiniteness in a permanent tax is over-capitalisation—a familiar feature in the existing structure of Indian industries. No doubt, the linking of the normal profits percentage to the efficiency formula[79] would greatly reduce this tendency but it seems discreet to limit capital to effectively employed capital only. Another feature in the Indian tax was the non-recognition of unrealised appreciations. Further, the tax, on the whole, ignored the liabilities side of the balance sheet.

Assets other than money.[80]

Assets of a business other than money were computed at their purchase price; if assets consisted of debts due to the business they were taken at the nominal amount. Other assets acquired otherwise than by purchase were computed at the value when they became assets of the business. The first and third of these were subject to deductions for depreciation needed to reduce the assets to the written down value, while the nominal amount of debt was subject to deduction as allowed for income tax purposes- Assets acquired otherwise than for cash were valued at the consideration actually given. Assets created without expenditure–for example, created good will,–were not computed as capital, but if purchased they were so computed perhaps largely because of administrative difficulties of calculation. A possible solution is presumptive valuation.

Borrowed money :

In the original 1940 Act[81] borrowed money and debt were generally excluded from invested capital, and, in particular, any debt for income tax and super tax or for excess profits tax in respect of the business. By an amendment of 1940[82] deductible debts included such sums in respect of accruing liabilities allowed as a

79. *Supra* p, 172.
80. Schedule II Section 1.
81. *Ibid.*
82. Excess Profits Tax Amendment Act of 1940, Section 2 (1).

deduction in computing profits. In the 1919 tax also borrowed money and trade debts were allowed to be deducted from invested capital. This rule was based on the English Act of 1939 which followed the act of 1915 where loans and debts were deducted in the computation of the invested capital.

But in one important respect the Indian Act differed from the British one and, as a result, was more equitable and advanced in its approach. It included bank loans and debentures used for increasing the capital and allowed interest thereon in computing profits. But advanced as this provision was, it did not go the whole way, for true equity demands not only that borrowed money should be included under capital and interest allowed on it but also that the statutory rate of profits, which is higher than the interest rate, should also be allowed on the loans.

Following a change in the British tax structure, India modified in 1941 the borrowed money provisions. By the Excess Profits Tax Second Amendment Act of 1941 all borrowed money was included in invested capital. "The amendment," observed the Finance Member,[83] "has the effect of removing the existing difference between the treatment in computing capital of money borrowed from a person carrying on a bonafide banking business and of money borrowed otherwise. It is proposed that from 1st April 1941 there shall be no deduction of money in computing borrowed capital and, consequently, as from that date interest or other consideration paid for the use of the borrowed money shall not be deducted from computing profits." This concession was given because it was considered reasonable and justifiable not to discriminate between different kinds of financing institutions. "The change that we are making," added Sir Jeremy Raisman, "is not by way of the admission of a mistake. It is a change of policy. It extends a concession to

83 *Legislative Assembly Debates.* *30th October 1941. PP. 287-288.*

the tax payer, the justification of which is arguable." The concession was not allowed to operate retrospectively but only from the beginning of April 1941 when the enhanced rate of 66 2/3 operated.

Following the British Act of 1939, the Indian Act excluded[84] from invested capital all outside investments, all capital the income from which was not taken into account in computing the profits and all moneys not required for the purposes of the business except where the principal business was making investment. This exclusion included temporary investments also.

Inadmissible assets

In this respect the Indian and British laws were fairer than the American law where investments by corporations were more freely recognised as capital though they were idle balances investments, securities or government bonds. This lattitude led to a substantial abuse of the provision in America. In India as in Britain the exclusion applied to government securities and bank deposits also.

Shipping[85]

One important exception to the foregoing rule was shipping. On account of the importance of shipping during war and the difficulty of replacing lost ships and also because the cost of replacement would be higher and so reserves for depreciation may not be immediately utilised for replacement, funds lying with shipping companies either as cash or investments from sale of ships or compensation for losses or the accumulation for depreciation were computed as capital employed in the business. As a corrolory the income received from such investments could be included in computing the profits. This provision relating to shipping was not contained in the 1919 Law. It was also not found in the United Kingdom where, if an asset had become obsolete or lost and subsequently replaced and the amount of loss was an allowable deduction, no allow-

84 Schedule *II*.

85 *Ibid.*

ance was given unless the asset was replaced. In India the postponement of replacement did not in any way affect the allowability or otherwise of the deduction claimed.

For ascertaining the average amount of capital, profits or losses were presumed to have accrued at an even rate resulting in an increase or decrease of capital employed.

Accumulated profits and losses[86]

Where profits of a part only of a business carried on by a non-resident or a person not ordinarily resident accrued in British India, then only the capital of that part was considered as invested capital. Where assets had been inherently unproductive in the standard period, their capital value was not taken into account in the standard period and in the chargeable periods. What was "inherently unproductive" was a question of fact to be decided as cases arose.

Special rules[87] were formulated for computing the invested capital of principal and subsidiary campanies. Generally. the rules relating to the British National Defence Contribution of 1938 and copied in the British Act of 1939 were adopted in India. When Britain herself altered them later, India followed the example.

Certain provisions of the Canadian Excess Profits Tax Act[88] relating to deductions from invested capital may be considered seriously in this country. Government subsidies to a firm were excluded in Canada. Similarly investments or uses of capital producing tax-exempt income were not computed. In view of the proposed planned development in India and of the possible financial aid given by the state towards capital equipment or trade expansion, the Canadian provisions offer a guidance. An alternative to the

86 *Ibid*,

87 Schedule III.

88 First Schedule 3

deduction of the amount from capital would be lowering the normal profits percentage—a solution which is not desirable because it would affect equally concerns receiving less or no financial help. If, however, such aid is given to the industry uniformly, the statutory percentage may be taken as that recommended by the Tariff Board, since such industries are also protected ones.

One important application of the statutory percentage has commonly been in the case of essential, new and depressed enterprises. As already pointed out, some enterprises of national importance were exempted completely from the tax in some advanced countries, for example, strategic minerals in U.S.A. and base metal and strategic mineral mines in Canada. No such provision was found in the Indian Tax of 1919 or 1940. Whatever the choice of industries for war purposes, the device of total exemption or of partial adjustment in the statutory percentage could be utilised in India in normal times in the case of industries "strategically important" in relation to the Economic Plan.

New Industries

New industries, however, were shown in India greater consideration than elsewhere. Not only were they allowed as their normal statutory profits 12 per cent on employed capital,[89] but they were also given other concessions, such as abnormal depreciation, and calculation of profits and depreciation allowances over the whole period of the War.[90] The Finance Member observed[91] that the enterpreneur, even if he has to face a serious recession, would at least have recovered the cost of his plant out of the war profits, for "surely it is not unreasonable that a new industry should expect to distribute 12 per cent as dividend during the war." Further, the new industry could appeal for a higher standard rate

89. Section 2. (21)

90. *Legislative Assembly Debates*—4th March 1941, Vol. II, No. 3, pp. 928—9.

91. *Ibid.*

than 12 per cent. This statutory rate may, however, be compared with 5 per cent from government paper and 6 or 7 per cent from industry in general. Even the high rate of 12 per cent was regarded by vested interests as inadequate and as "killing the infant industries in India." "I shall have to be content with 12 per cent", bemoaned Sir Abdul Halim Guzhnavi.[91] "What is 12 per cent to a new industry? What is the reserve? What about the losses that will stare him (the entrepreneur) in the face in the future after the war is over? You take away all and leave that new industry to die after the war." As T. Chapman Mortimer, one of the European businessmen from Calcutta retorted,[92] "I should say that, if it is a deterrant to new industry in this country to be taxed on excess profits tax when its profits rise beyond twelve per cent, then all I can say is that I am disappointed in the spirit of the Indian capitalists."

Not only was the rate of 12 per cent high enough but the greater mistake lay in making it the minimum and thus introducing partial rigidity into the standard rate. If the normal rate prevailing in similar industries is lower or if, for other reasons,-such as protective tariffs or import control, state aid regarding finance, technical help and guaranteed market at controlled prices—the industry deserves less, the Board of Referees is fettered in its award by the minimum of 12 per cent. That is why in Canada, for instance, the case of new industries, i.e. those started after 1938, was to be investigated by the Board of Referees who could allow "the rate earned by taxpayers during the standard period in similar circumstances engaged in the same or analogous class of business."[93] This is definitely preferable because it allows the appellate authority complete discretion without any rigidity either at the top or at the bottom.

91. *Ibid* p. 981. Compare *Ibid* pp. 994—5 for a similar reaction of a Bombay magnate.

92. *Ibid* p.971

93. *The Canadian Excess Profits Tax Act of 1940*, Section 5(2).

Another adjustment of the statutory percentage which India might copy has generally been in the case of depressed industries. In Canada[94] a maximum of 10 per cent on employed capital was allowed on appeal to the Board of Referees and the Minister. Where capital was not important in a business or the business was abnormally depressed, the Board could go a step further and award a norm having regard to the standard profits of tax-payers in similar circumstances in the same or analogous class of business. And in the case of gold mines and oil wells, the norm could be calculated on the basis of a presumed volume of production.

Drepressed industries

In Great Britain was found a more interesting provision. Adjustments in the statutory percentage were permitted in the case of wasting assets. The Board of Referees could allow 8 and 10 per cent, instead of 6 and 8 per cent, to the extent of the capital of a wasting nature employed in oil wells, mines and similar natural resources; but in no case could the increase exceed four per cent over the ordinary normal statutory percentage. In special cases, however, for example, where the output of certain essential mining and oil industries was increased in order to help the war, the standard of profits could be increased on a time-scale as below:

1946—50	...	...	30 percent
1951—60	...	...	20 percent
1961—70	...	...	10 percent
1971—90	...	...	5 percent

India had no such device and her statutory percentage lacked adaptability. The Excess Profits Tax Second Amendment Act of 1941 provided[95] that in the case of oil and other minerals, wasting assets may be provided for by appeal to the Central Board of Revenue which may order an equitable allowance in

94. *Ibid* Section 5(1)
95. Section 26 (3)

computing the profits of the chargeable accounting period. While deferring the consideration of providing for such assets by large depreciation and similar allowances, the value of the British procedure described above may be emphasized here. Although in emergencies the British device is capable of only short-period application, in a permanent tax the time scale may be utilised in the determination of the statutory percentage applicable to the special industry. The degree of variation in the standard rate, the period of such modifications and the question whether the time scale should beregressive as in the United Kingdom or progressive depend on particular industries and the extent of their wasting nature and of their relative place in the national economy. But the time-scale principle may be usefully adopted in India.

THE TAX RATE

The rate of the tax was fixed in 1940 at 50 per cent of the excess,[96] but liable to annual review. The following table compares the Indian rate with those of some other countries :

96. Section 4.

TABLE XXX

Tax rate as per centage of excess.

	INDIA.	UNITED KINGDOM.	U.S.A.	CANADA.
1915	—	50	*	§
1916	—	60	—	
1917	—	80	20 to 60	25
1918	—	80	30 to 80	50 to 75
1919	50	40	20 to 40	,,
1920	—	60	,,	,,
1921	—	40	,,	20 to 60
—			$	$
1939	—	60		10 to 60
1940	50	100	25 to 50	75
1941	66½	,,	35 to 60	
1942	,,	,,	100	
1943	,,	,,	,,	
1944	,,	,,	,,	
1945	,,	,,	,,	
1946	,,	,,	,,	

* N.D.C. and Armament Profits Duty operated priot to 1938.

§ Declared Value Excess Profits Tax operated from 1934.

$ Where the rates were graduated, the maximum and minimum are mentioned.

The reaction to the rate is revealing. Business interests in India bitterly opposed the levy of 50 per cent. Repeated attempts were made in the Legislative Assembly, both in the Select Committee and during the debate on the clauses of the bill, to reduce the rate or at least to graduate the tax. "If you make it as substantial a percentage as you have in the bill," observed Sir H.P.Mody,[97] "you are preventing industries from consolidating their position." "This bogey of 50 per cent is enough," exclaimed another Bombay magnate[98] "God knows what things are going to happen." The Muslim Chamber of Commerce

97. Legislative Assembly Debates, 6th February 1940 vol, I No. 1 p. 105.

98. *Ibid.* p. 115.

considered [99] it objectionable both in its incidence and application. "It will take away 50 per cent of my profits," lamented a Calcutta businessman.[100] "Hardly an Indian concern in infancy can stand it . . . Ten years of depression have ruined the market in India. What profits has the war given ?"

This attitude is very similar to the protest of the American Senate Finance Committee minority in 1935 which characterised the Revenue Act of that year as "a bill to confiscate property; to discourage business and prevent its expansion; to destroy incentive aud discriminate against ability, brain, ambition and enterprise. . . . and for other improper purposes."[101]

The grounds of objection in India to the 50 per cent duty were many. First, the rate was regarded as unprecedented in the country. "During the last war," said a member of the Legislature,[102] "we had either the super tax or the excess profits tax. Now we have the supertax continued and in addition we are now asked to pay the excess profits tax. That is the difference between then (1919) and now (1940)." Secondly, industrial development was said to be hampered. "It is a very big slice and it will have very bad repurcussions on the development of industries." [103] Thirdly, the rate would retard capital formation. "That capital is proverbially shy," pointed out Baijnath Bajoria,[104] "is a matter of common acceptance and a number of fine remunerative industrial propositions have been hanging fire for want of adequate capital. Even

99. *Ibid*. p. 120.

100. *Ibid* 14th March 1940, Vol. II No. 6. p. 1337

101. *A.E.R.* 1935, p. 688.

102. *Legislative Assembly Debates* 13th March 1940. Vol. II, No. 5. p. 1291, Also compare the protest by the Federation of Indian Chambers of Commerce, *ibid*,

103. *Ibid* p. 1297.

104. *Ibid*.

some key industries have been known to suffer for want of fresh capital. I would, therefore, ask the Government to examine this aspect of the question seriously. The imposition of a heavy burden like the payment of 50 per cent would seriously deplete the cash resources of our industries with the result that any capital programme that we may have in view will either have to be suspended, or, in any case, considerably delayed." The excess profits tax would leave no cash resources with the existing industries to expand and seriously discourage investment in risky new enterprises. It was further contended that the British example (60 per cent) could not be followed in India since Britain was a richer country and industry there had been receiving for years government orders in anticipation of war, whereas India had no such advantage and was just recovering from the depression. Finally, as the tax was imposed to meet emergency expenditure, the required revenue could be raised by a lower rate. "In the case of a country like England which is spending crores everyday, it is only 60 per cent fixed; in the case of India, which is not spending or is unable to spend anything like it, the percentage should be at least half of that. . . ."[106] "All this", concluded a critic,[107] "is sheer speculation, sheer gamble at the cost of the poor people."

The Government, however, rightly refused to yield to these protests. "I feel very strongly," replied the Finance Member,[108] "that the agitation and the criticism on the subject of the 50 per cent is entirely unreal—I would almost say, it is meaningless. We have strong moral justification for claiming that the share of the state in the excess profits should

105. *Legislative Assembly Debates* 14 th March 1940 Vol. II, No.6 p.1346

106. *Ibid* 15 th March 1940, Vol, II, No.7, p.1387

107. *Ibid*

108. *Ibid* p. 1390.

not be less thon 50 per cent." The soundness of Sir Jeremey's stand is borne out completely by a detailed analysis of the objections.

Regarding the 1919 precedent: It has been already pointed out [109] how during the First World War it was a mistake not to have introduced the tax earlier. Moreover, financial theory as well as practice underwent in the interwar period–1919 and 1939–a revolutionary change and the whole outlook of society and of the state became entirely different. About 1919, financial theory looked up to Bastable [110] and the nineteenth century school of thought, and financial practice was Victorian. But by 1940 even the views of Josiah Stamp [111] looked oldish. The slogan was "We need not scruple to levy duties considerably beyond the standard of ancient Egypt."[112] The relative importance of direct and indirect taxes, the rate and structure of the income and super taxes, the variety of new taxes and the quantum and direction of expenditure in the budget of any advanced country, such as Great Britain, indicate the change. It is suggestive to follow the attitude of such an authoritative and balanced weekly as *The Economist*. The journal thus commented on the British budget in 1919," [113] If our worst fears are justified and the government really have in contemplation a complete revolution of the fiscal system under which this country has attained its economic might, in Heaven's name let the Government tell the country its plans frankly and without delay. When such proposals are brought into the open, we trust to the common sense of the business community and the country generally to see that they are either withdrawn or defeated at

109. *Supra* p. 261.

110. *Public Finance*, 1903.

111. *Fundamental Principles of Taxation in the Light of Modern Developments* 1921 and 1936.

112. *The Economist*.

113. *Ibid* 31st May 1919, p. 989.

polling booths." But, twenty-five years later, the same journal wrote,[114] "The enormous expenditure and deficits of these wartime years would not fit into any pre-war definitions of soundness. But they are the unavoidable fruit of total war and "soundness" is now to be measured by the extent to which these enormous dislocations and crushing burdens are provided for without social disaster and political disruption. The end of the story is yet to be written."

Regarding the effects on industrial development: I have discussed above[115] how these fears are unfounded both in theory and as evident from experience during theFirst World War. Even in countries such as Great Britain and the United States where the tax was imposed for a longer period and at a higher rate, the fears were found false. Further, the tax is not on profits in general, but on the *excess* over a norm which in India has been higher than elsewhere both in the exempted minimum (Rs. 36000) and the statutory percentage as well as in profits of the standard year.

It was no more accurate to claim that the

TABLE XXXI

Index of industrial production, 1932–40-

(Base 1935—100)

	INDIA.	U.K.	U.S.A.	CANADA.
1932	80	79	67	72
1933	84·4	84	79	74
1934	92·2	94	86	90
1935	**100**	**100**	**100**	**100**
1936	105	110	119	111
1937	111	118	126	123
1938	118	110	103	111
1939	122	117	129	122
1940	136	...	144	159

114. *Ibid* 17th April 1943 p. 486.

115. *Supra* pp. 223 and ff.

116. *Statistical Year Book of the League of Nations* 1945. Also *The Capital* and *Statistical Summary of the Social and Economic Trends* in the inter—war period Table X.)

depression had affected Indian industries to a much greater degree and that their recovery about 1939 was slower than in other countries. This is obvious above

It may be noticed that our industries were well on the road to recovery and certainly not far behind other nations.

Nor can the objection on grounds of capital formation and reserves be held sound. The following data reveal the position of four important industries in India.[117]

TABLE XXXII

Reserve position of some industries
(India 1928-43. Base 1928—100)

	COTTON.	JUTE.	TEA.	COAL.
1928	**100**	**100**	**100**	**100**
1929	108	107	109	99
1930	110	107	109	113
1931	109	106	113	114
1932	102	104	113	125
1933	99	102	111	131
1934	109	101	111	137
1935	92	99	111	133
1936	...	99	111	138
1937	...	100	109	147
1938	103	97	109	162
1939	101	95	109	153
1940	111	97	109	157
1941	104	100	119	151
1942	121	106	133	231
1943	125	101	177	169

It is clear that, except for a very short period about 1935, the reserve position has been sufficiently sound. The tendency, in fact, appears to have been *not to plough* back excess profits into business but to distribute them as dividends.[118]

117. A detailed study of this problem will shortly be published under the caption: " Reserve position of some Indian industries—a statistical study."
118. *Supra* Ch. III.

The contention that the United Kingdom was a richer country and so justified a high rate of tax is specious. The inequalities of wealth are more marked in India. The excess profits tax affects the rich classes and does not touch the poor masses unless they run a business, earn a profit of more than Rs. 36000 per year and make an excess gain. About 2500 assessees were found in this country of 400 millions.

The revenue argument also misses the mark. For, as the yield of the excess profits tax and the amount of war expenditure proved later, neither of them could be gauged even approximately. Although the immediate origin of a tax may be an emergency it is definitely unwise to relate any tax or the revenue therefrom with any particular item of expenditure. Many of the Finance Member's difficulties in the Legislative Assembly would not have arisen had not the tax been linked so closely with the war expendture.

It was this miscalculation of the yield that soon led to a revision of the rate. The fundamental fairness of the tax and the growing financial need led to the rate being increased to 66 2/3 percent in the budget of 1941. The Finance Member again pleaded [118] that "the new level of the tax will neither cause substantial hardship to existing industries nor operate to impede the growth of ones." The yield was expected to increase by $2\frac{1}{2}$ crores.

Big business again complained. "It is not only 66 2/3 percent which a person has to pay for his excess profits tax, because, apart from his excess profits tax, he has to pay incometax, super tax and surcharge on the balance of his excess profits." The tax of a company was calculated at 80 per cent of its profits.[120]

The tax, however, was continued at 66 2/3 percent throughout the war. But in 1942 a new feature,

119. *Legislative Assembly Debates* 4th March 1941, Vol. II, No. 3.

120. *Ibid.* pp. 990—991.

the compulsory deposit, was introduced. The government very cleverly exploited the businessman's plea of the need for reserves and attempted to prevent evasion by wasteful expenditure, while at the same time followed in effect the British and Canadian examples of a 100 per cent tax. The compulsory deposit was, in fact, a compulsory reserve available to the depositor after the war. The scheme was explained by the Finance Member thus :[121]

"We have been impressed with the growing evidence of the extent to which the tax militates at certain stages against the incentive to the most economical and efficient administration of the business affected. We also felt that there is great force in the argument for the supreme importance of building up a reserve for rehabilitation and re-equipment of national industries after the war. Finally, there is here also a strong case for immobilising during the war as much as possible of the excess profits earned and preventing postponable private expenditure from exerting an undesirable influence on the price level. To assist in securing these objects we are prepared to *contribute* an amount upto and not exceeding *one tenth* of the net excess profits tax ultimately paid at the rate of 66 2/3 percent provided that the *assessee deposits an amount equal to double this amount*. The contribution thus placed in reserve by the assessee will be repayable *within twelve months of the end of the war* and will in the meantime earn *simple interest at the rate 2 per cent per annaum*. The portion contributed by the Government will also be paid out after the war at such time and subject to such conditions as may hereafter be determined. Advice on the formulation of these conditions will be sought from the Post-War-Reconstruction Committee. The Government contribution will together with the interest on the assessee's deposit be a taxable receipt of the year in which it is repaid."

121. *Legislative Assembly Debates* 28th February 1942, Vol. I No. 13 page 636. The deposit or refund device was used in U.S.A., U.K. etc.

The essence of the scheme, thus, was :-(1) the rate of the tax would be 66 2/3 per cent (2) the assessee would further deposit one fifth of the amount or another 13 1/3 per cent i.e. in all 80 per cent (3) the deposit would carry interest at 2 per cent (4) the government would repay the deposit with interest a year after the end of the war (5) the government would also at its convenience return to such depositors 1/10 of the *tax* paid i.e. 6 2/3 per cent, thus reducing the net tax rate to 60 per cent and (6) the amounts so repaid and returned would be taxable incomes.

This was a very clever scheme which, if completely successful, could achieve many objects. It would prevent inflation to some extent by raising revenue and restricting consumption. It would act as a compulsory public loan. It would stabilise industries after the emergency by the release of reserves, when needed, to stimulate recovery from the post-war depression. It would, for all practical purposes, raise the tax rate during the war to 80 per cent, though ultimately, after the war, the rate would work out to 60 per cent. This unusual and unorthodox expedient like similar ones adopted elsewhere may be traced to J. M. Keynes' 'forced savings scheme' although Keynes' idea applied to a different class of citizens.[122]

In 1944 the limit of the compulsory deposit was raised from 1/5 to 19/64[123] in order to mobilise the entire excess profits left over after payment of the excess profits, income and super taxes on such profits. The fraction of 19/64th represented exactly the balance that would be left in the case of a company after payment of the taxes. But in the case of persons other than companies who were liable to the super tax at slab rates, the profits left after the payment of taxes would have been very small. In such cases the compulsory deposit was reduced to 17/64ths. And it was further provided

122. *How to Pay for the War*: 1940.

123. The Indian Finance Act of 1944.

that if, on assessment, it was found that the income tax and super-tax payable by a person on the balance of excess profits exceeded 15/64ths, the deposits would be correspondingly reduced so that the compulsory deposit, the income tax and the super tax payble on the excess profits did not exceed the balance of the excess profits left after payment of the excess profits tax of 66 2/3 per cent.

The rate held good until the abolition of the tax in the budget of 1946 from the 31st March.

In Great Britain the Finance Act of 1941 provided[124] for the repayment after the war of 20 per cent of the tax paid at the rate of 100 per cent. i.e. the net excess profits tax and the National Defence Contribution would be reduced to 80 per cent of the excess. The refundable amount carried no interest. In the United States,[125] a post-war refund credit of 10 per cent was given, for each taxable year after December 1941. The payment was to be in the form of government Liberty Bonds without interest and maturing on the last day of the calendar year after the cessation of hostilities. The proceeds of the redeemed bonds were not included in gross taxable income. The Revenue Act of 1944 fixed the net tax rate after refund, at 85½ per cent.[126] In Canada also the refund amounted to 20 per cent on the tax rate of 100 per cent of the excess profits,[127] the repayment commencing from the second fiscal year after the war with a time schedule for repayment. Thus, the amount due on 1942 account was repayable as above, that due on 1943 account was repayable in the third fiscal year and so on.

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124. Part III Section 28, modified by Section 37 of the Finance Act of 1942.

125. Section 780 of sub-chapter E of Chapter 2 of the Internal Revenue Code, of Regulation 112. 1941. There was a time schedule for the redemption of bonds. Vide *ibid* Section 780, subsection (c)

126. Section 250.

127. The Canadian Excess Profits Tax Act of 1940, as amended in 1942, Section 18.

Two important differences between these countries and India were :—(1) They offered no interest on the returnable amounts and (2) the net tax rate after refunds was at least 80 per cent of the taxable excess. In India the rate of the tax was $66\frac{2}{3}$ per cent (less a refund of $6\frac{2}{3}$ per cent.) The deposit was an additional $13\frac{1}{3}$ per cent carrying interest and in view of the deposit being compulsory, it was as good as a tax except for the interest. Thus, while other countries taxed at 100 per cent and returned without interest 20 per cent, India taxed at 80 per cent and returned 20 per cent, part of it carrying interest. Why the Government should have been so generous in an emergency is strange, but even this generous gesture was criticised in India as inadequate.

In the budget of 1946,[128] the Finance Member made the further concession of refunding the deposits in advance of the date for which the law provided, "on condition that they are distributed as dividends to shareholders but are required for the provision or replacement of buildings, plants or machinery."

Another point of contention in the Legislative Assembly in 1940 was the application of the slab system to the excess profits tax. In 1919, the device was practically unknown in taxation, but by 1940 it had come to stay in income and other taxes. When their efforts to reduce the rate of the excess profits tax failed, business interests pressed for the slab system. One of the scales suggested was :[129]

The slab system

30 per cent on excess profits not exceeding				Rs. 20,000.
35	,,	,,	between	20,000 and 70,000
40	,,	,,	,,	70,000 and 170,000
45	,,	,,	,,	170,000 and 370,000
50	,,	,,	Over	370,000.

128. *Legislative Assembly Debates*, 28th February 1946 p. 1738.

129. *Ibid* 15th March 1940, Vol, II, No. 7, p. 1377.

Another (Sir Raza Ali's) was slightly heavier.[130]

35 per cent on excess profits not exceeding				Rs. 30,000
40	,,	,,	between	30,000 and 60,000
45	,,	,,	,,	60,000 and 100,000
50	,,	,,	,,	100,000 and 150,000
55	,,	,,	,,	150,000 and 200,000
60	,,	,,	Over	200,000.

But the principle itself was not accepted, The Finance Member opposed it [131] on grounds of principle as well as financial grounds. On principle, three objections were put forward. First, as the profits tax has nothing to do with the total income of the assessee but affects the excess above a norm, the principle of making the larger income pay at a higher rate does not hold good. Graduation, therefore, may work entirely perversely. Secondly, in the case of companies to whom the excess profits tax mostly applies, neither the income tax nor the super tax is graduated on the slab system. Finally, smaller businesses may be treated more fairly by raising the exemption limit.

The applicability of the progressive principle to the excess profits tax has been pointed out already.[132] Much of the Finance Member's reasoning holds good of progression based on *amount* as applied in income taxation but not of graduation based on the *rate* of excessivity, irrespective of the amount. Thus, if business 'X' earns excess profits of 50 per cent on capital, it could and should be taxed at a higher rate than business'Y' which earns an excess of only 20 per cent. The degree of excessivity as indicated by the rate ought in equity and could in practice be a basis for graduation on the slab system. While progression according to *excess amount* would certainly act

130. *Ibid*, p. 1395.

131. *Ibid*, p. 1382.

132. *Supra*, pp. 53 and ff.

perversely, the same principle according to *excess rate* would act equitably and would also distribute the burden of the tax according to ability to pay amongst the "profiteers". This is illustrated below. Secondly, the parallel of the income and super taxes does not hold good because they are not business taxes and have ultimate reference to the individual taxpayer. Financially also, graduation if steep enough, e.g. as suggested by Sir Raza Ali,[133] would increase the yield as compared to a low flat rate.

The effects of the flat and progressive rates as well as the practicability of the latter are shown below by applying the rates to the case put forward by a Bombay businessman in the Indian Legislature. Opposing the slab system, Sir H.P. Mody said :[134] " Suppose a business (let us call it 'X') has an income of Rs. 30.000 in the standard year and an income of Rs. 240,000 in the chargeable accounting period, the excess is Rs 210,000. Under your (Sir Raza Ali's) scheme of things that business would have to pay 60 per cent of the excess. Take another case. (Let us call it 'Y') A business has got an income of 50 lakhs in the standard year and Rs. 5035000 in the chargaeable accounting period. Under your scheme of things that business would be paying only 35 per cent. Which is the richer party ?......The amendment (Sir Raza Ali's) would perpetuate a monstrous injustice, because a business having a profit of as much as 50 lakhs and more might pay only at the rate of 35 per cent or nothing at all, and a business which has a profit of a little over 2 lakhs pays 60 per cent of the excess profit. Where is the justice in this scheme of things?......" This is certainly grossly unjust partly because the richer firm is taxed less on excess profits and partly because its huge standard profits are perpetuated. The injustice is inevitable where the Income Standard is applied and

133. *Legislative Assembly Debates* 15th March 1940, Vol. II, No. 7 p. 1399.

134. *Ibid.*

the rate is graduated according to the *amount* of excess.

Under the Capital Standard and progression based on the *rate* of return, the equity of the differential treatment becomes obvious and this is illustrated below : The capital of the two firms 'X' and 'Y' are assumed ; the normal rate of profit is taken as 10 per cent and, for the sake of simplicity, it is not linked with efficiency ;[135] and the tax rates are those suggested above [136] as reasonable for a permanent tax.

TABLE XXXIII

The Slab System Illustrated.

	FIRM. X	FIRM. Y
Employed Capital	5 lakhs	200 lakhs
Profits (amount)	240000	5035000
,, (rate)	48%	25o/o
,, (norm allowed) (rate) ...	10 o/o	10%
,, ,, ,, amount ...	50000	20 lakhs
,, taxable excess ,, ...	190000	3035000
,, ,, (rate) ...	38%	15%

TAX RATES

SLAB.		TAX.
I.	Normal profits 10o/o	nil.
II.	Excess below 5o/o	20o/o of excess.
III.	,, between 5 and 10o/o	25 ,,
IV.	,, ,, 10 and 15o/o	30 ,,
V.	,, ,, 15 and 20	35 ,,
VI.	,, above 20	40 ,,

TABLE XXXIV

The Slab System illustrated (Contd.)

I. *Income Standard without graduation.*

	FIRM X.	FIRM Y.
Total profits	240,000	5,035,000
Standard profits	30,000	5,000,000
Excess ,,	210,000	35,000
Tax at 40o/o	84,000	14,000

135. *Supra* pp. 168 and ff

136. *Supra* p.58.

II. Income Standard *with graduation* (Sir H. P. Mody's example quoted above.)

Total profits, Standard ,, Excess ,, — as in I above.		
Tax at 60 o/o	126,000	—
,, at 40%	—	14,000

III. Capital Standard *with graduation according to total income.*

Employed capital	5 lakhs.	200 lakhs.
Total Profits	240,000	5,035,000
Normal ,, allowed (10o/o on capital)	50,000	20 lakhs.
Excess ,, (amount	190,000	3,035,000
,, ,, (rate)	38o/o	15o/o
Tax at 40o/o	76,000	—
,, at 30o/o	—	907,500

IV: Capital Standard *with graduation according to the slab system.*

Employed capital	5 lakhs.	200 lakhs.
Total profits	240,009	5,035,000
Normal ,, (allowed) 10o/o on capital	50,000	20 lakhs.
Excess profits (amount)	190,000	3,035,000
,, ,, (rate)	38o/o	15o/o

			CONCERN X.		CONCERN Y.	
Slab.	Profit rate.	Tax rate.	Profits.	Tax paid.	Profits.	Tax paid.
I.	10 per cent on capital	nil.	50,000	nil.	20 lakhs.	nil.
II.	Excess of 5 ,, ,,	20o/o	25,000	5,000	10 ,,	200,000
III.	,, 5 to 10 ,,	25o/o	25,000	6,250	10 ,,	250,000
IV.	,, 10 to 15 ,,	30o/o	25,000	7,500	10 ,,	30,0000
V.	,, 15 to 20 ,,	35o/o	25,000	8,750	35,000	122,250
VI.	,, over 20 ,,	40o/o	90,000	36,000	...	...
TOTAL	—	—	240,000	63,500	5,035,000	762,250

The incidence of the tax under the different methods compared.

			I.	II.	III.	IV.
Employed Capital						
	Firm	X		500,000		
		Y		20,000,000		
Total Profits						
	,,	X		240,000		
	,,	Y		5,035,000		
Normal Profits						
		X	30,000		50,000	
	,,	Y	500,000		2,000,000	
Taxable Excess						
		X	210,000		190,000	
	,,	Y	35,000		3,035,000	
Tax Paid						
		X	84,000	126,000	76,000	63,500
		Y	14,000	14,000	907,500	762,250

Not only is the richer firm Y made to pay more than X and more than under the Income Standard, but it is guaranteed a reasonable profit in relation to its huge capital. Further, as its profits are not very excessive and so liable under the last slab, it is treated more considerately than under the III method.

At first sight, the application of the slab seems complicated administratively. But the method is already in practice under the income and super taxes where the number of assessees is very large. In the excess profits tax, the number of assessees may not be beyond 5000 under existing conditions.

COMPUTATION OF PROFITS

General Application of Income-Tax Principles[137]

Except in some particulars the Indian Act followed the British Act of 1939. The word 'profits' was not defined except in terms of the rules in accordance with which profits were to be computed. These rules applied both to the standard and to the accounting period. This implies that profits became assessable on the basis of accural and not of

137. Schedule 1 Rules 1 and 2,

remittance which holds good under the income tax. Otherwise, profits were computed on income tax principles, subject to certain modifications, and apportioned where accounting periods were not co-terminus with standard periods or chargeable periods. Whenever possible the data collected for income tax purposes were to be utilised and wherever necessary modified to fit them to the needs of the excess profits tax. In the British tax the profits were separately computed, though according to income tax principles. This needless duplication was avoided in the Indian tax of 1940 as was done in the British tax of twenty years ago.

Where the standard period was two years, profits and losses were apportioned. Interest and salaries paid outside British India were excluded from computation, though included for income tax purposes; and it is only right since these items are in the nature of expenses from the standpoint of the business, though income from that of the individual. Profits of insurance businesses, other than life insurance which was exempted, were computed as per income tax rules. The following deductions were allowed in computing profits, viz: rent paid for premises, repairs to premises where assessee was the tenant, interest on capital borrowed, insurance premia, current repairs to building, plant, etc, depreciation, obsolescense, dead or useless animals, land revenue and local rates, etc., bonuses to employees, bad debts and business expenditure. On the whole, the tax base was narrower than for income tax purposes.

Income from Investments [138]

The Indian tax was largely a trading profits tax. Therefore, as a general rule, income from investments was not included for the computation of profits. There were, however, certain exceptions viz: the incomes from investments of building societies, money lending and

138. Schedule II (3). Compare the British Finance Act of 1939. Schedule III (7)

banking, insurance, letting out property on hire and businesses which pertain wholly or mainly to investments, were considered as profits. Where profits of a subsidiary company were included in the excess profits tax assessment of the principal company, dividends of the subsidiary company out of such profits were not included in the assesment, the object being to avoid double assessment. A distinction was drawn between companies and other persons in the matter of deduction of the capital borrowed for purposes of allowing interest on loans. In the case of companies the capital borrowed was reduced to the extent of the value of the investments, whereas in the case of other businesses it was so deemed only if the investments were mortgaged, charged or pledged as security for the loan.

India could very usefully have copied the provision relating to modification on account of variations in capital value as it obtained in the British law of 1915. According to this provision, the Excess Profits Duty authorities—the Commissioner in this instance—could grant deductions from investment income in cases where, owing to the dimunition in the general purchasing power of money, there was a decline in the market standing of the security from which the income was derived. This would relieve much of the burden of the tax from bearing too heavily and inequitably.

Depreciation, Depletion, etc.[139]

Depreciation was allowed in India on the written down value as defined in the Income-Tax Act. In 1942 the definition of the term "written-down value" was revised thus: "the value of the assets acquired before the previous year has to be computed by deducting from the actual original cost of such assets all depreciation actually allowed to the assessee concerned." This provision was criticised as anamolous on the ground that profits calculated on this basis would

139. Schedule I (3)

be higher compared to profits calculated on the original value basis which held good in the standard years i,e. prior to 1939. This criticism, however, is only superficial, for the procedure adopted was essentially sound and just as evident below :

Suppose a business has :

	Invested Capital	Income	Depreciation allowed at 10o/o	Net taxable amount
Standard year and original value basis (1939)	Rs. 5 lakhs	1 lakh	50,000	50,000
Taxable year and written down value basis(1940)	Rs. 4,50,000	1 lakh	45,000	55,000

Apparently the excess profits of Rs 5,000 seems artificial since a depreciation of 45,000 and not 50,000 is allowed in 1940. Really, however, although the total amount of income has been the same in the two years, i.e. one lakh, it is in 1940 the yield on a capital of four and a half lakhs and not five lakhs as in 1939. Assuming that half a lakh allowed for depreciation in 1939 has not been invested, the written down capital has obviously yielded a proportionately higher return. viz : 21% in 1940 as against 20%in the previous year. The dictum of comparing " like with like ", if adopted, would lead to absurdities in this case and allowing the same amount of depreciation year after year would be, as S.P. Chambers put it,[140] almost incredible. All that is necessary is that the full amount of the asset should be allowed over the period of the life of the asset and this was done in the Indian Act.

No special depreciation was allowed in India for excessive wear and tear of machinery, etc. during the war. Such an allowance was found in the British tax,[141] which gave the concession to buildings, plants and machinery provided they were used since 1937 for purposes arising out of war and they were likely

140. *Legislative Assembly Debates* 9th February 1940, p. 248.

141. Seventh Schedule, Part I.

not required for other purposes. Originally meant to apply to armament firms under the Armaments' Profits Duty, the provision was extended to all industries when the excess profits tax was introduced. "I hope", observed the Chancellor of the Exchequer[142], " this extra allowance will encourage traders generally to embark on developments and extensions for purposes connected with the war."

It may be noted that the concession did not extend to all capital, as was suggested by some critics in the Indian Legislature,[143] but only to the part added after 1937. In view of the control over investments and prices, there would not have been much harm in adopting a similar provision in India. The degree of wear and tear in abnormal conditions would differ in different industries. Depreciation of two types should, therefore, be provided for. Ordinary depreciation might follow the income tax rules and might be fixed for classes of trade or business at rates agreed upon by the assessee and the assessor. There must also be *always* in an emergency levy, and *generally* in a permanent tax, provisions for depletion, obsolesence and amortisation. This must relate to *all assets* employed in the business and not to a few specific items of investment. The principle of arbitration may be followed with blanket power to the Board of Referees or other authorities to consider particular cases of appeal. Any capital, not necessarily relating to war supplies, must come within the scope of this provision, and the allowance must equate the difference between the value of the asset at the beginning of the first accounting period and the market value of some post emergency date so as to charge off the dimunition in value. Such a concession is necessary because a war always leads to overworking the assets and to such improvements in technique and capital

142. *House of Commons Debates on Finance Bill* (No. 2.) of 1940 4th Oct 1939.

143. *Legislative Assembly Debates op. cit.*

that pre-war plant becomes obsolete.

Exceptional depreciation was allowed in India only in the case of certain buildings which were erected during the period of war but which might on the disappearance of the war conditions become almost valueless.[144] The Act allowed in such a case a deduction of the differences between the value of the building at the date its value was reduced and the written down value deductible in arriving at the profits of the chargeable accounting period. Provision must also be made for depletion and wasting assets in the case of mines and similar gifts of nature. This could be done both by granting additional statutory percentage and extra depreciation allowances.

Another feature in the Indian tax was that the depreciation allowance was not carried forward as for income tax purposes.[145] This was the practice generally in other countries also. Since the time of charging the renewal is important in a short period tax with avowdly financial objectives, carrying forward would affect tax revenue though it would add to equity. But in a permanent excess profits tax as in a permanent income tax, no revenue would be sacrificed, while greater justice would be done if carrying forward is allowed especially if the averaging of profits over a period of years as suggested by me earlier [146] is allowed for assessment purposes—only the period of carrying forward the depreciation should be limited to the period of averaging profits.

In 1944[147] Great Britain introduced a rough and ready but bold scheme of depreciation and other

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144. Schedule I (10)

145. *Ibid* (3)

146. *Supra* pp. 186 and ff.

147. The United Kingdom Finance Act, 1944 part IV, Sections 27 and ff. *Vide* the 1944 budget speech of the Chancellor of the Exchequer. *The Economist* pleaded in January 1943 (2nd January 1943, pp. 17-18) for a revision in this direction.

allowances, and in the next year India attempted half-heartedly to copy her in the Income Tax and Excess Profits Tax Amendment Bill. The provisions of the bill applied mainly to income tax but since the income tax principles applied equally to the excess profits tax and since depreciation is allowed only once and not cumulatively with reference to every tax affecting a business, exclusion of the excess profits tax was not material.

The bill proposed, as in Great Britain, a special depreciation allowance in respect of new buildings erected and new plant and machinery installed after March 1935 at the rate of 20 per cent for plant and machinery and 10 per cent for buildings. "The granting of these allowances," said the Finance Member,[148] "will only hasten the writing off of assets and will not increase the over all allowance, because the maximum that can be allowed in respect of any asset is 100 per cent of its cost. Even so it should provide encouragement for the early reequipment of industry."

The bill was defective in two respects. It did not provide, as was done in the United Kingdom, a wear and tear allowance (2 per cent in the U.K.) and it did not exempt from taxation the amount spent on research. The significant feature of the British scheme of 1944 was the exempton of all research expenditure from taxation. In extending the concession to expenditure of a capital nature such as laboratory buildings, plants and machinery, as well as to current expenditure such as salaries. wages and materials, Sir John Anderson observed, "In this comprehensive attempt to relieve from taxation altogether funds devoted by industry to the support of fundamental research, to the translation of laboratory research to production and to the full-scale development of the product, the Board of Inland Revenue have tackled the problem with a sense of realities born out of their close interest in the effects

148. *Legtslative Assembty Debates* 8th March 1945 pp. 1207 and ff.

of taxation upon industrial recovery and the buoyancy of the revenue."

Not only were the sense of reality and sympathy lacking in India, but also the ameliorative part of the bill relating to depreciation was unwisely linked to its departmental side giving additional powers to the authorities for preventing evasion. And as the latter was bitterly opposed in the Legislative Assembly, the Finance Member hastily withdrew the whole bill.

In March 1946, however, Sir Archibald Rowlands the new Finance Member, reintroduced only the ameliorative part in the Indian Incometax(Amedment) Act. The provisions applied only to the income-tax as the excess profits tax had been abolished earlier in the year. But since these concessions should have been given earlier and especially in connection with the excess profits tax, they are described below.

While introducing the bill, Sir Archibald assured the Legislature[149] that "it does nothing but confer concessions upon the taxpayers," and was "to encourage Indian industry to rehabilitate and reeqiup itself and make itself more efficient." The Act introduced four improvements in the existing practice Firstly, a special depreciation allowance was given to buildings at 10 per cent and to plant and machinery at 20 per cent of their cost. This was in addition to the existing normal depreciation allowance; it was, moreover, not taken into account in determining the value of further depreciation, and finally, it was not reckoned for excess profits taxation.

Secondly, the regulation allowed money spent on research as deductible expediture for income tax purposes. The concession, which acted retrospectively from 1945, covered both revenue and capital expenditure, and applied not only to research expenditure incurred by an undertaking itself but also covered grants made by it to recognized research

149. *Ibid.* March 15 the 1946, pp. 2489 and ff

institutions. This allowance was subject, in the case of a dispute, to a ruling by an independent prescribed authority.

Thirdly, the scope of the obsolescence allowance was extended and expanded. It was extended to industrial buildings, shops, offices and hotels. The allowance included not only assets that had been discarded as no longer required but also those destroyed or demolished. Further, only the difference between the original value and the written down value was treated as taxable.

Fourthly, the Act exempted from taxation for two years residential buildings erected within the next two years and allowed on business buildings an additional initial depreciation of 5 per cent.

These provisions represent an enlightened fiscal policy and form one of the most important contributions to industrial taxation. They mark a turning point in the outlook of the Indian Finance Department. But they did not go the complete way. For, the rate of depreciation and the need for reequipment differ between industries, since technical progress is unpredictable. A uniform allowance introduces rigidity into the scheme and discriminates against rapidly changing industries. Not only, therefore, should the allowance vary from industry to industry but should also be periodically readjustible. No doubt, it is impossible to anticipate technical progress and provide legislatively for such changes. But, the needed flexibility can be introduced by fixing the minimum and maximum concessions and allowing an appellate authority to determine the effective rate for each class of trade or industry. This is of particular importance in a country like India which is in the process of industrialisation.

The Indian tax, although following the British

levy, was not so liberal. In the United Kingdom the main principle was, in the words of the Chancellor of the Exchequer,[151] that "the aggregate amount of the excess profits tax payable throughout the operation of the tax will be the tax corresponding with the net excess profit over the whole period, after allowing for any falling off of profits in any year." In India there was no such provision. Relief was given where a deficiency of profits occured in any chargeable accounting period. Deficiency was considered to exist where profits made in the period fell short of the standard profits or where a loss had been incurred in that period. The amount of deficiency in the former case was taken as the amount by which the profits fell short of the standard profits and in the latter the amount of the loss added to the amount of the standard profits. Loss did not include capital losses. Only trading losses were considered. The loss had to arise out of the business and be in the chargeable accounting period but one which was appropriate to a particular accounting period could be deducted even though it was not actually made in that period. Losses in non-taxable businesses could not be deducted, nor could losses be ordinarily carried forward. By an amendment of 1941, a deficiency accruing after March 1941 could be set off against an excess in that period.[152]

Losses and Deficiency of Profits.[150]

Neither in India nor in the United Kingdom did the law allow, as the British law did in 1915, deductions from current profits to allow pre-war losses if profits were actually applied to the extinction of such losses. The 1940 practice was very hard on the assessee because businesses sometimes wait for years to make up their losses and it would not do to allow only the losses suffered after the

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150. Section 7. Compare the British Finance Act (2) of 1939. Section 15.

151. Consideration of the Finance Bill (2) of 1939. House of Commons Committee, 4th October 1939.

152. Section 4 of the E.P.T. Amendment Act of 1941.

tax was levied to be set off. A period of pre-tax losses also must be considered in the computation of standard profits. An alternative solution to eliminate injustice and avoid complication in calculation would be the universal adoption of the percentage standard. It would have been good if India had followed in this respect not the British Act of 1939 but the British Excess Profits Duty of 1915. Considering a business as a continuing operation, the law of 1915 not only allowed losses to be spread-over subsequent to the tax but also gave special relief for losses prior to the tax.[153] As R. M. Haig put it long ago,[154] the importance of this provision in eliminating friction and discontent can be scarcely over-estimated. Whatever the method of relief in a temporary tax, in a levy which is either permanent or lasts for a number of years the most equitable solution would be the averaging of profits over a series of years. In the case of India the period for averaging might be put down as five years, though in the cases of some industries such as jute, tea and coal it may be extended.

Remuneration of Directors and Managing Agents[155]

To prevent evasion by the distribution of profits in the guise of salaries and directors' allowances—a danger particularly acute in the case of concerns owned and managed by the same persons—the tax law was everywhere strict. In India in the case of director controlled companies, directors' remuneration was not allowed to be deducted in computing profits, both of the accounting period and of the standard period, where the profits standard held good. The exclusion did not relate to the remuneration of a whole time director or manager who did not control more than 5 per cent of the ordinary capital, or of a managing agent whose managing agency business was liable to the excess profits tax. Companies in which

153. Finance Act (2) of 1915, Fourth Schedule Part I. Rule 7.

154. *Report on the Taxation of Excess Profits in Great Britain*, p. 47.

155. Schedule I (7).

the directors had a controlling interest were thus placed on the same footing as firms and partnerships which were not allowed to deduct partners' salaries. In this respect the Indian tax followed the British law of 1939 which itself was based upon the Act of 1937 relating to the National Defence Contribution.

Under the British law of 1939 directors' remuneration in excess of what held good in the standard period was not allowed, but under the Indian Act no deduction could be made in respect of directors' remuneration.[156] Obviously, this was a serious omission in the Indian Act, since any reasonable remuneration to the directors should be regarded as a legitimate part of the expenses. What the reasonable amount is may by fixed by the appellate authorities, if the amount paid in the standard years is regarded as too much. But to deny altogether such allowances as expenses is unfair. Such a denial may, no doubt, put the director-controlled companies on an equal footing with partnerships, but the proper solution appears to be to allow a reasonable remuneration in both cases and not to exclude it altogether. The additional administrative inconvenience caused thereby is certainly worth the justice rendered.

Remuneration to managing agents at a higher rate than the one that was in force in the standard period was disallowed for purposes of the Indian excess profits tax. This rule was added by the Select Committee and was peculiar to India and not found in Great Britain because the managing agency system is a peculiar Indian institution. Such remuneration, where it had been included in the profits of the managing agent's business, was, for purposes of excess profits taxation, put on the same footing as remuneration of whole-time service directors.

Where a contract extended beyond the accounting

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156. *Ibid*, sub-rule (3)

period such proportion of the profit or loss as was attributable to the accounting period was considered for excess profits taxation in India. This was a departure from the income tax practice where it was not taken into account unless there was an ascertained profit or loss. The excess profits tax practice was definitely fairer, though it was not clear whether the apportionment was to be based on the work performed or the capital employed in the accounting period. Further, the Indian Act provided that, after the contract was completed and the profits finally realised, if the aggregate of the amount attributed to the previous accounting periods exceeded the realised profits, adjustments would be made to reduce the liability so attributed.[158] This was an improvement upon the British tax where there was no such provision. The Indian tax, however, would have been still better if, as was the British practice in 1915, the apportionment plan had been applied to the pre-tax standard years also so as to prevent evasion, since the total profits of a long period contract realised in a standard year may be claimed as the exempted norm.

Long Term Contracts.[157]

As in the British tax, the Indian excess profits tax was applied to the net profits of a business before any deduction was made for income, super and excess profits taxes. Thus, the first claim on the profits was of the excess profits tax, but the amount of excess profits tax payable in British India as well as outside, after relief by repayment, set off, etc., was deducted as expense for calculating income for income and super tax purposes. Further, a tax payable by a principal company in respect of profits of a subsidiary company

Income and Profits Taxes.[159]

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157. Schedule 1 (9)

158. Ibid

159. Schedule 1 (b)

was similarly deducted but put to the credit of the subsidiary and not the principal. The provision was not found in the British tax.

Double Taxation Relief [160]

The Central Government could provide relief if the excess profits tax had been paid both in British India and in an Indian State or in the Dominions if the laws of the other country provided corresponding relief. Where there was no provision for relief in the other country, relief was given to the extent of half the Indian tax or half the tax payable in the other country, whichever was less, provided (1) the profits arising outside India had been charged to the tax in this country, (2) no relief was provided in the other country in respect of the excess profits tax, (3) the assessee had paid the tax in that country also and (4) the tax had been paid in respect of the same profits.

No provision was made for relief under similar circumstances in the case of countries other than the United Kingdom, an Indian state or the Dominions where there was provision for relief. An amendment of 1940 provided for cases of hardship, where a United Kingdom company paid in that country 100 per cent of its excess profits, the whole of the company's profits being earned in India, and received no allowance for such excess profit tax in computing the profits for the Indian income tax purposes, because none of the profits actually arose in the United Kingdom. If the tax was paid in that country in respect of the deficiency of the profits in a chargeable accounting period it was taken into account for Indian income tax purposes whether such a period was a chargeable accounting period in India or not.

Actual Profits

The Indian Act took into account the actual profits accruing in the accounting period though they were computed on the same principle as in the standard period i.e. on the arising basis. In a temporary tax whose life is

160. Section 11.

uncertain, the averaging principle adopted in the income tax cannot generally be applied because of the administrative difficulties of calculating profits and of the scope for evasion. This, however, results in hardships necessitating a variety of adjustments like rebates for years of depression and exemption of depreciation of asset values. If the tax is to remain on a permanent footing, it is best, in the interests of both the tax-payer and the Treasury, that the averaging system suggested earlier is adopted.

Loans from Banks and Debentures.[161]

Where increase in capital was effected after the standard period by raising loans from a bank or by debentures, interest on them was not allowed to be deducted and the loan itself was not deducted in arriving at the amount of captal. An allowance at a standard percentage of 8 or 10 per cent was given as against the actual rate of interest on such loans. This concession was confined to loans from bonafide banks and debentures, and the extension of its provision to all types of loans was rejected and rightly too. Referring to this concession which was not found in the British tax was definitely an improvement on it, the Finance Member said "Originally there was no such provision in the bill. But we were impressed with the desirability of making some concession in this direction if it could be done without greatly complicating the adminstration of the tax and opening a wide door to evasion. We advanced as far as it was possible to do without opening a wide door to evasion and I am quite convinced that if we advance a step further, we shall make it possible for loans to be given and taken and for the capital ranking for standard percentage to be inflated in an unwarrantable manner. This, no doubt, would be resisted by the officers administering the tax, but it would lead to a tremendous amount of argumentation and altercation and would very greatly complicate the

161. Schedule I (5)

administration of the tax." Although administratively the course adopted was the best it was possible to be a little more considerate and equitable by adopting the presumptive capital principle suggested earlier.§

Adjustments allowed administratively

In cases where, either in the standard period or in any chargeable accounting period, a deduction was allowable for income tax purposes which did not represent a sum reasonably and properly attributable to such a period, power was given to the Excess Profits Tax Officer to make suitable adjustments. The power was a wide one and applied to any accounting period and all deductions. If the officer felt that a deduction allowable for income tax purposes did not represent a sum attributable to the accounting period, he allowed only a part, the balance after deduction being attributable to another accounting period or periods as he felt proper.

ADMINISTRATION

Importance

The success of any tax depends considerably on the administrative factor. The British more than any other people realised the fundamental importance of good administration, particularly in the case of the excess profits tax, which requires the very finest ability in annalysing the accounts and in making the complicated adjustments. When he introduced the Excess Profits Duty in 1915 McKenna pointed out that the question of increasing the taxes was as much a question of machinery as anything else. In fact, the levy of the tax was delayed in 1914 until administrative efficiency was assured.[162]

The best tax can be made ineffective by inefficient or indifferent execution, whereas an indifferent tax can be made comparatively successful by efficient administration. The American economist, R. M.

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§ *Supra* pp. 179-180

162. *Vide* R. M. Haig's valuable remarks based on British experience, Haig's *Report* pp. 93 and ff.

Haig, after a detailed survey, records his admiration of the British for the recognition of the importance of administrative work. It appears to have been one of the most striking points of contrast with the American situation.

The extent of efficiency in administration depends upon the size of the problem to be tackled. Thus, if there is a large number of assessments to be made, for example, about 50,000 in the U.K. under the Excess Profits Duty or thrice that number in the U.S.A., the burden on the adminstration is heavier. On the other hand, if, as under the Indian tax of 1940, the number of assessees is 2,500 the problem becomes easier. It further depends on the quality and number of the administrative staff. The remarkable success of taxes and especially of the E.P.T. in Britain is largely traceable to the admirable staff in the Inland Revenue Office. "It has always been the pride of the British Government in regard taxation," said Bonar Law[163], "that evasion should not be permitted." Similarly, the comparative failure of the excess profits tax in America is traceable to the poor quality of the administration. This is specially important in the administration of a new tax which like all other new taxes is unpopular and invites evasion.

It is, therefore, necessary to build up a dependable staff adequate in number and quality to operate the tax. It is further, equally, necessary to vest the staff with authority, responsibility and discretion. For no tax law can be comprehensive, able to meet all cases. Extensive powers of interpretation and modification should be given to the direct administrators of the tax. It was here that Great Britain scored over other countries. "A mere reading of the statute is sufficient to show, "writes R.M. Haig,[164]

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163. *Ibid.*

164. *Ibid*, p. 94

"the striking extent to which they depend upon administrative discretion in assessing and collecting the duty." Of course, that country has had the advantage of an experience of more than a century of income taxation, a levy akin to the excess profits tax.

India has been under many disadvantages in respect of administration. To start with, the Indian E.P.T. law was, as pointed out above, not very satisfactory. "Any scheme for the levy of a special tax upon such increase of profits," explained the Finance Member,[165] "can at best be of a somewhat rough and ready nature, no matter what degree of thought and care have gone to the devising of the enactment that gives effect to it." Our experience of income taxation has been really short. Although it was introduced 80 years ago, it became a permanent feature of our finances hardly 3 decades ago, and the sturcture and administration of the tax were until the Second World War not modern. The administrative machinery was also not as efficient as the British Inland Revenue Department. C. W. Ayers, the tax expert of the Government of India,[165] ascribed the delay in assessments and administration of the E.P.T. as due to the late working of the E.P.T., the time needed for drafting forms, notifications etc., and extensions of time. "Further, the staff had to administer the income tax of 1939 and the excess profits tax was something of which they had no experience and which is full of pitfalls. You cannot produce a trained staff at a moment's notice. You can take on new hands and give them three to four years' training and if you are fortunate, you have a first rate officer at the end of five years". Moreover, the country being vast and possible assessable businesses dispersed, the scope for evasion would be large.

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165. *Legislative Assembly Debates* 28th February 1945 p. 875.

166. *Ibid.* 11th November 1941, pp. 637—639.

Such evasion would find a further temptation and excuse in the imposition of the tax by a foreign government and for the prosecution of a war not endorsed by the peoples' representatives. Finally, it is doubtful if the civic conscience of the Indian tax payer is as developed as that of the British one. These factors make the problem of effective administration in India more complicated and the need for it more urgent.

The excess profits tax authorities in India comprised the Central Board of Revenue, Commissioners, Assistant Commissioners–appellate and inspecting—Excess Profits Tax officers, and the Board of Referees.[167] All these except the Board of referees were controlled by the Central Board of Revenue.

Central Board of Revenue

The Central Board of Revenue corresponded to the British Commissioners (or Board) of Inland Revenue and the American Bureau of Internal Revenue. Its functions were supervisory, regulative and appellate. Subject to the control of the Central Government, the Board could make rules regarding appeals, refunds, investment companies, adaptation of the Excess Profits Tax Act to the Income Tax Act, etc.[168] It could appoint the other excess profits tax officers (except the Board of Referees) mentioned above and assign them duties.[169]

Its powers of relief were two: (1) in respect of the standard profits, and (2) that of the chargeable accounting period.[169] It could also give relief in certain special circumstances. e.g., new businesses and nascent industries. In some hard and special cases such as depressed industries, where the assessee considered that special circumstances rendered it inequitable that the standard profits should be

167. Section 3

168. Section 27.

169. Section 3 (3)

170. Section 25

computed in the ordinary way, the Central Board could give relief in the standard rate but generally not exceeding the statutory per centage. Similarly where capital was not important in the business, for example, stock broking or where the preliminary or developmental expenditure had been heavy, as in the the steel industry, or where it was a pioneer industry, that is, one in which production had not been undertaken prior to April 1932, for example, automobiles or aircraft, the Board could give relief in the standard profits.

More important, however, were its powers relating to the computation of the chargeable accounting period,[171] for, this applied to most of the hard cases. Thus, where the profits were artificially inflated by the postponement of renewals and repairs or where extra expenditure on plants and buildings not useful after the war had been incurred or in the case of losses sustained or difficulties experienced in the remittance of foreign incomes to India, the Central Board could grant relief. Similarly, it could interfere in the allowance of directors' remuneration in the chargeable accounting period as well as in the standard period.[172] The decision of the Board was final. The relationship between the Central Board and the Board of Referees was a matter of importance and is considered below.

Board of Referees

The Board of Referees consisted of not less than three and not more than five persons, of whom not less than one half were non-officials having business experience and one a senior judicial officer who had held office for not less than ten years.[173] The Central Government constituted a panel of eligible persons and appointed a board of them whenever an appeal was to be heard. The appellant could object to any member of the

171. *Ibid*

172. Schedule I. Rule 7.

173. Sections 3 and 6.

Board and the Commissioner gave his ruling on the objection. The members selected their own chairman and the majority decision held good.[174] The Board was not subject to the control and direction of the Central Board of Revenue.

The functions of the Board were (1) to decide upon and determine the standard profits of the standard period and, if necessary, to fix a new level of such profits, and (2) to decide, in cases of transferred ownership, the relative liability to the tax. The Board could be approached generally by businesses which were in the process of developing and had not earned a reasonable standard of profits and by those suffering from industrial depression. Such businesses could apply to the Excess Profits Tax Officer who referred the matter to the Board of Referees. If it was satisfied, the Board could have the profits computed at a higher amount. It determined the basic figure for ascertaining the standard profits but it had no power to vary the statutory percentages. Its powers were discretionary and not subject to any control of the Income-tax Department or the Central Board of Revenue. It was not bound by any special rules or methods for ascertaining the amount. The only limitation on its powers of determining the amount was that such amount should not exceed the statutory percentage on the average amount of the capital employed in the business, unless the Board was satisfied that, owing to some peculiar cause, a greater amount should be allowed. In such peculiar specific cases the Board could allow an amount greater than the statutory percentage but the powers of the Board in this respect were not so wide as under the English law where, in the case of businesses carried on by persons other than companies, there was no limit to the amount which the Board might arrive at.

The decisions of the Board were final in that once the standard profits were fixed, the amount

174. Excess Profits Tax (Board of Referees) Rules, 1940.

applied to all subsequent years. But if insufficient relief had been granted by the Board, the Central Board of Revenue could under Section 26 (1) of the Act, direct that the standard profits be computed at a higher amount.

A period of not less than sixty days from the date of service of notice for return was given. The return was to be related both to the profits of the business and to the standard profits or the amount of deficiency available for relief. Accounts of foreign businesses were not called for if audited statements of accounts could be determined in any other way without calling for the books.

Assessments[175]

The assessing officer determined the profits liable to the tax, the amount of the tax payable or, if there was any deficiency, the amonnt of deficiency and the amount of the tax repayable. The liability to pay the tax was on the person carrying on the business in the chargeable accounting period. If two or more persons jointly carried on the business, the assessment was made on them jointly; for, the tax was on the business as a whole and not on the individuals who owned the business. There was, therefore, no provision, as in the Income tax Act for assessing the tax on the individual members of a firm.

As the case of the income tax, the taxpayer was allowed to pay his dues by instalments. Profits escaping assessment, either because of underassessment or excessive relief or any other reason, could be reassessed by the Excess Profits Officer within five years of the end of the chargeable accounting period.

Appeals[176]

An appeal to the Appellate Assistant Commissioner against the orders of the Excess Profits Tax Officer lay in the following cases: successions amalgamations, amount of the tax assessed, liability for assessment, penalty

175. Sections 13 and 14,

176. Sections 18 and 19.

imposed, deficiency of profits assessed, relief allowed and refusal to grant relief. Decisions regarding apportionment of deductions were appealable to the Board of Referees. Although the period of limitation for appeal was 45 days, the Assistant Commissioner could extend the period. He had the power to enhance the assessment or penalty in appeals. Appeals to the Commissioner and later to the appellant tribunal lay against certain orders made by the Appellate Assistant Commissioner. The appellate tribunal had all such powers in disposing of appeals as it had in respect of appeals preferred to it under thc Indian Income Tax Act. It could rectify mistakes and enhance the liability of a person within a period of four years from the date of the order sought to be rectified.

Evasion

Tax evasion is an exciting and sometimes profitable, though always anti-social and dangerous, game. Prevention of evasion depends as much on the structure of the tax law as on the efficiency of and powers vested in the tax administrators. New ways of outwitting the law are regularly discovered, and, accordingly, a constant revision is necessary to close up the loopholes. Whereas even in 1918 the British Chancellor of the Exchequer evidenced pride in the skill and ability of the Inland Revenue Department, and others familiar with the British tax system "expressed the most complete scorn for those countries which permitted tax administration of their revenue laws,"[177] the Indian Finance Member was complaining nearly three decades later[178] that "everybody knows evasion is going on to a very large scale. There are lots of other holes which we should go and stop......The difficulties in the Indian scene are undoubtedly greater than those to be

177. *Report on the Taxation of Excess Profits in Great Britain*, pp. 94-95.

178. *Legislative Assembly Debates*, 8th March 1945, p. 1328.

contended within the United Kingdom in the income tax administration."

The remedies lie in strengthening the hands of the administration and in the imposition of heavy penalties on law breakers. The common ways of evasion, such as, unnecessary and extravagant expenditure and fictitious and artificial transactions were met in India by the Excess Profits Tax Second Amendment Act of 1941, while evasion in the form of incomplete or false accounts was proposed to be countered more rigorously by later amendments. The method generally adopted elsewhere and also in India was to increase the powers of the tax officers in re-opening and inspecting accounts to get at the true position of the concern. Thus, under Section X of the Excess Profits Amendment Act of 1941, the Excess Profits Tax Officer could, with the approval of the Inspecting Assistant Commissioner, make adjustments in profits retrospectively to counteract the reduction of liability. Similarly under clause VII, the Excess Profits Tax Officer could, with the permission of the Commissioner, disallow, in the computation of the profits of any chargeable accounting period, expenses which he considered unnecessary to the requirements of the business, and also limit them, for example, in the case of directors' fees and similar other payments for services rendered. But the assessee could appeal to the appellate tribunal against any such order.

These powers were wider than in Great Britain and were characterised in the Legislature[179] as doing "the greatest injustice to the assessee." In fact, not only were conditions in India and Britain different,[180] but, as the Finance Member pointed out, "Such a power is not meant to be used every day and that is why he (the Excess Profits Tax Officer) must get the prior authority of the Commissioner and the application must

179. *Legislative Assembly Debates*, 30th December 1941, p. 290.
180. *Ibid* 11th November 1941, p. 766.

come to the headquarters. Our own experience has shown that it is necessary to have this power. When cases come to headquarters they receive careful personal attention of the highest authorities and even of myself."

The powers proposed by the Income Tax and Excess Profits Tax Amendment Bill of 1945 were even more drastic. This bill had an ameliorative side dealing with depreciation, etc. which is dealt with elsewhere. On its departmental side, it proposed to empower tax officers to enter business premises, seize and impound accounts and reopen assessments. Similar proposals with reference to income tax had been unsuccessfully made eight years earlier. On the basis of experience and the need for more powers to the administration to check increasing evasion, the bill was revised but it was opposed on grounds, political, social and even religious.[181] It was said to take away the liberties of the people and interfere with privacy. The critics alleged that the British parallel was quoted " to strengthen fetters over the general public in India." The bill was therefore withdrawn.[182]

The opposition was partly correct. But the opportunities for evasion are definitely more in India. The tax payer's public conscience certainly has been, like the tax gatherer's efficiency, of a lower order than in the United Kingdom. Consequently, stricter provisions for evasion, more powers to the administration and heavier penalties are needed in this country. The basic principles in the Amendment Bill appear to have been sound, though the period for the reopening of the assessment and the powers to visit businesses and to call for accounts could have been toned down. In Australia and other countries, the Commissioner or any officer authorised by him could have full and free access to all buildings, places, books,

181. *Legislative Assembly Debates.* 8th March 1945 Vol. IV, No 7. pp. 1209 and ff.

182. *Ibid* 2nd April 1945, Vol. IV. No. 1 p.2309.

documents, etc. and there has been no objectionable interference with liberty and privacy. The remedy lies not in with-holding powers but in the choice of efficient and discreet tax officers to apply them.

Penalties were imposed for breaches of the law. A fine equal to the maximum amount of the excess profits tax payable could be levied for failure to furnish returns and failure to produce accounts or documents or concealment of particulars of profits or capital employed or for deliberate inaccurate accounts. The penalty was in addition to the tax payable. False statements and declarations carried a fine of Rs.1000 or simple imprisonment for six months or both. Prosecution under the Indian Penal Code was barred where the offender had been punished under the excess profits tax law.

FISCAL AND ECONOMIC CONSEQUENCES.

A tax is judged by its consequences—immediate and remote, intended and unintended. The immediate intended effects of the Indian Tax were fiscal. Its great productivity in indicated below:

Tax receipts.

TABLE XXXV E.P.T. Revenue in India and elsewhere (1939—47)

Year	India: Total tax Revenue	India: E.P.T. under corporation tax	India: E.P.T. under income-tax	India: E.P.T. Total receipts	U.K.: Total tax Revenue	U.K.: E.P.T. Receipts	U.S.A.: Total tax Revenue	U.S.A.: E.P.T. Receipts	Canada: Total tax Revenue	Canada: E.P.T. Receipts	S. Africa: Total tax Revenue	S. Africa: E.P.T. Revenue
	(in crores of Rs.)				(in millions of £)		(in millions of $)		(in millions of $)		(in millions of £)	
1915-16	....	....	....	....	290	0·14	....	....	....	....	....	....
1916-17	....	....	....	....	514	139·9	....	....	....	....	....	....
1917-18	....	....	....	....	613	220	....	....	....	....	....	....
1918-19	....	....	....	...	784	285	....	....	....	....	....	....
1919-20	56·4	....	....	....	998	290	....	....	....	....	....	....
1920-21	....	....	..	11.3	1032	219	....	....	....	....	....	....
1921-22	....	....	....		857	30	....	....	....	....	....	....
1939-40	80·6	....	....	....	1017	26·9	5952	18	468	....	33	....
1940-41	77·1	1·08	0·47	1·55	1358	96	7554	....	778	24	34	3
1941-42	99·7	7·02	1·68	8·69	1951	269	13382	....	1361	135	50	7
1942-43	124·8	23·51	5·75	29·21	2482	377	22469	5146	2129	455	66	12
1943-44	171.1	39·86	13·71	53·57	2948	498	42115	9482	2592	429	79	14
1944-45	153·8	67·44	24·67	92·11	3134	510	43591	11000	2552	425	88	13
1945-46	283·2	68·33	11·18	79·51	3196	486	....	....	....	....	....	....
1946-47	240.5	66·00	12·00	72·00	3010	325	....	....	....	....	....	....
1947-48 B.E.	176	35·00	5.00	40·00	....		....	....	....	....	....	....

Note:—Data for India Govt. accounts & budget; for U.K. the *Economist*; for U.S.A., Canada, and S. Africa: *League of Nations Monthly Bulletin* of *Statistics*

The social and fiscal significance of the tax during the First World War was small on account of the very short duration of the levy. The problem, however, was different in 1940–46. Although receipts were less than in other countries their relative importance in the Indian budget was great, approximately about 19 per cent of the total revenue and about 30 per cent of the tax receipts. All the excess profits tax revenue, however, was not a net gain. For, the yield of the income and sur-taxes was reduced in view of those taxes not being charged on the excess profits tax payments. It is also possible that the government paid more for its supplies as shrewd businessman may have taken the probable tax liability into account before charging prices on government contracts, especially in a country like ours where controls worked unsatisfactorily.

A quarter of the receipts were either deposits or refundable amounts. Moreover, if there had been no such levy, the abnormal gains would have been assessed under the ordinary income and super taxes with their surcharges. The net revenue as well as the burden of the tax would, therefore, have been much less than the receipts indicate, probably of the order of 175 crores as shown below:

The rates of the income and super taxes have varied from year to year as well as between earned and unearned incomes, and the 'slab' device does not apply to all the assessees. The maximum rates, however, were[188] :—

	Income-tax.	Surcharge.	Super tax	Surcharge.	Total
1943-44	2-6	1-8	2-0	2-6	8-8
1944-45	2-6	2-0	3-0	3-0	10-6
1945-46	2-6	2-3	3-0	3-0	10-9

188. *Vide* A. G. Banerjie: *Income Tax Law and Practice* (1946) Chapter X. The rates are in annas and pies per rupee.

At half the maximum rate, say one-third of a rupee, applying to the excess profits tax receipts the revenue and burden of the tax would be:

Excess profits tax receipts (1941-46) crores		350
less refunds of 1/10th	35	
and compulsory deposits	52	
		87
	87	
Net revenue		263
Income and super taxes with surcharges at 1/3 of a rupee		88
Net addition from excess profits tax		175

This calculation excludes the burden from alternative sources of revenue to replace the excess profits tax, for example, the Business Profits Tax of 1947, or an increase in customs duties or excises.

A sidelight on the efficiency of the tax administration is thrown by comparing the budget estimates and receipts.

TABLE XXXVI

E.P.T estimates and actuals. India and U.K, (1939-47)

	India				U.K.		
	Budget Estimate	Revised Estimate in crores Rs.	Actuals	o/o variation between B.E. & actuals	B.E. in £ m.	Actuals	o/o variation between B.E. & actuals
1939-40	....	....	....	....	25	26·9	+4·0
1940-41	3	2	1·5	—50	70	96	+39·0
1941-42	11	8	8·6	—12	210	269	+29·0
1942-43	19	26	29·3	+54	455	377	—11·0
1943-44	40	62·2	53.5	+32	500	498	—0·2
1944-45	78	110	92·1	+18	500	510	+2·0
3945-46	90	90	79·5	—24	500	486	—8·0
1946-47	75	72	....	....	325	....	....
1947-48	40	....	....	....	....	....	....
1915-16	....	....	....	....	....	·14	....
1916-17	....	....	....	....	86	139.9	+64
1916-18	....	....	....	....	200	220·2	+10
1918-19	....	....	....	....	300	285	—5
1919-20	....	....	....	....	280	390	+3·5
1920-21	....	....	....	....	215	219	+1·9

Data for U.K. (1915-21) from Mallet and George : *British Budgets, Second Series* Table XIII ; include E.P.T. and Munition Levy ; and 1939-47 from *The Economist*

The contrast between the United Kingdom and India in this respect is striking. In the former country the divergence between the estimates and actuals was considerable in the early years of the levy, i.e. before the tax system settled down. After 1917, and after 1942, there was close correspondence, testifying to the accuracy of the forecast and the efficiency of the administration.

It is, therefore, difficult to explain, except in terms of administrative inefficiency, the wide gulf between the estimates and receipts in India. On the introduction of the tax in 1940 the Finance Member stated :[183] " This figure can only be estimated in the roughest way. Any attempt at precise calculation is rendered impossible, not only by the difficulty of evaluating the scale of profits in war time, but by the fact that the basis with which they are to be compared must vary with the option of the numerous individual assessees to choose their standard periods. Moreover, the portion of excess profits actually brought under assessment in the course of the coming year will in the ordinary way be dependent on the dates on which the normal accounting periods of the businesses affected terminate and the dates by which the assessments can be completed. Finally, as the machinery for administering the tax has yet to be brought into being, the work of assessment cannot begin till many months of the year have passed." But, things did not change in the next year and the Finance Member again pleaded : "As regards the excess profits tax, the extent of the preliminary work proved even greater than had been expected with the result that the returns were not due from the assesses before the end of November. The subsequent stages of the assessment proceedings bristle with practical difficulties owing to the complexity of the computations. And to these difficulties ordinarily associated with the excess profits

183. *Legislative Assembly Debates*, 29th February 1940, Vol. I. No. 15 P. 879.

tax, there is the added difficulty of a separate depreciation computation owing to the change-over in the income tax law to the written-down value basis for depreciation. For these reasons, the progress of excess profits tax assessment has been, and, is, very slow and the actual receipts in the current financial year are not expected to exceed Rs. 2 crores. A substantial portion of the original estimated receipts for 1940–41 will accordingly go to swell the collections of 1941–42. This sum may be taken as of the order of Rs. 1 crore."

But matters did not improve with experience. In 1942 also Sir Jeremy Raisman apologetically observed[185] that "the actual receipts of the excess profits tax during the current year are put at no more than 8 crores out of an anticipated Rs. 11 crores. This is largely due to an overestimate of the extent to which the increase of the rate of the tax to 66 2/3 per cent would affect the current year's yield, the assesment actually being made almost wholly in respect of liabilities at the rate of 50 per cent. . . . There has been in recent months a considerable improvement in the progress of assessments and these are now being made at the rate of over Rs. 1 crore of tax a month." But no such divergence between estimates and receipts was found in Great Britain when she increased the tax rate by 40 per cent,—from 60 to 100 per cent—whereas an increase of only 16 2/8 per cent in India was marked by such an overestimate. In fact, considering the larger number of assessees in Britain, the divergence should have been larger in that country than in India.

In short, the lack of correspondence between the estimates and receipts characterised the tax in later years also. Between 1940 when the tax was first levied and 1946–47 the latest year for which the revised estimates at least are available, the total estimates and

184. *Ibid* 28th Feb. 1941, Vol. II No. 1 pp 879—880.
185. *Ibid*, 28th Feb 1942 Vol. I No. 13 p 621.

the actuals were respectively 316 and 350 crores i.e., a divergence of 10·8 per cent, whereas in the United Kingdom between 1939 and 1946, the difference between the actuals and estimates was only 1·5 per cent. The conclusion is thus forced that administration in India is not of the same order of efficiency as in Britain and that many of the objections to and defects of the tax may be traced to this factor. It is also possible that the large area of the country, the wide dispersal of the assessable concerns and the lower civic sense among the assessees may have added to the difficulty.

Effect on business

Probably the greatest fear about the tax has been its repressive effect on production. Even in normal times, industrial activity is affected by various forces such as taxation, commercial policy, controls, if any, and the capital market—sometimes pulling their weight in the same direction and sometimes in opposite directions. It, therefore, becomes difficult to seggregate the influence of the different elements. The difficulty is increased in abnormal times. Nevertheless, an attempt is made below to indicate the course of business activity during 1939-1946:—

TABLE XXXVII

Index of Industrial Activity (1939—46)

(*Base 1935=100*)

YEAR	INDIA $							CANADA	U.S.A.
	Cotton	Jute	Steel	Iron	Paper	Coal	All		
1938-39	120·4	121·8	113·4	108 6	115·1	118·1	118·0	99	99
1939-40	114·3	128·0	124·3	127·1	147·8	120·1	122·0	128	114
1940-41	128·2	110·8	139·1	136·5	183·6	124·5	137·1	177	147
1941-42	150·3	122·1	157·3	141·5	193·2	116·6	146·8	278	187
1942-43	154·4	117·8	144·2	130·6	153·9	114·7	135·1	273	217
1943-44	167·3	99·7	149·2	136·3	148·0	109.7	135·0	267	214
1944-45	159·2	103·2	128·0	125·6	155·9	112·1	130·6	258 (April) 1945	220 (May 1945)
1945-46	161·0	106·0	151·8	96·9	151·3	127·0	132·3	...	...

$ Data from *The Capital* of Calcutta.

Data for Canada and U.S.A. from *The Statistical Year Book* 1945 and *Monthly Bullettin of Statistics of the League of Nation*

There was on the whole neither deterioration in industrial activity nor much of expansion. In some industries such as cotton and steel improvement was noticeable, while in others such as jute and iron production decreased a little.

The problem may be looked at from another angle. The number of companies and the amount of paid-up capital increased between the pretax and tax years:—[186]

	No. of Companies	Paid-up capital (Rs. in crores)
1938-39	11114	290·4
39-40	I1372	303·7
40-41	11617	302·8
41-42	12176	315·5
42-43	12993	313·3
43-44	13921	309·0

There was no retardation in this directon. Even under the rigorous restriction of Capital Issues Control, between May 1943 and July 1946—the period when the tax rate was $66\frac{2}{3}$ per cent with the compulsory deposit device also in operation—the applications for new issues amounted to 594 crores of rupees, consents to 425 crores and refusals to 169 crores. Of the permitted capital issues, 265 crores, related to industrial concerns and the balance, to non-industrial.

The following data relating to the new capital issues clearly indicate that enterprise and investment were on top during the period of the tax:—*

	Immediate schemes				Long- range schemes.			
	Applications		consents		Applications		Consents	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
May 1943 to Sept 1945	1143	227·4	809	161	471	256·4	376	218·8
Oct. 1945 to March 1947	4411	288·9	3537	166	249	96·2	247	94·5
Total	5554	516·4	4346	327	720	352·6	623	313·3

* *Reserve Bank of India Report on Currency and Finance* 1946-47, statement XXIX. For further analysis of capital isses. *Vide* the interesting note by S. L. N. Simha in Reserve Bank Bulletion, Feb 1947, pp. 84-87.

186. *The Eastern Economist* 20th July 1945, pp. 79-80

There is therefore, little to indicate that the excess profits tax affected industrial activity. This inference is borne out by the experience of others. In Canada and the United States as well as in the United Kingdom, the excess profits tax was heavier and for a longer period, and yet production expanded more rapidly than in India. The contrast between the first two of these countries and India is marked. In the United Kingdom the increase in industrial activity between 1939 and 1943 was more than 50 per cent as against less than 20 per cent in our country. In the same period the British national income increased from £ 4604 millions to £ 8712 millions, whereas in India it rose from Rs. 2500 crores to Rs. 3000 crores.[187]

The slower growth of industrial activity in India may be traced not to the excess profits tax nor even to the tax policy in general but to the industrial policy of the government, which threw away the golden opportunity for expansion and did not encourage industrialisation to the same degree as Canada or the U.S.A. did.

Effect on Prices

It has been pointed out above [189] that the profits tax has generally little influence on prices, though under certain circumstances, such as imperfect competition, it may act as an excuse for charging higher prices. In India, where price controls were incompletely effective, black marketting plentiful and inflation unprecedented, it is possible that the tax was made an occasion for increasing prices. But the net effect is not ascertainable, though the following data suggest that the tax could not have had directly much to do with prices :—

187. *Ibid* 7th September 1945, pp. 347-3.

189. *Supra* pp. 207 and ff.

TABLE XXXVIII

E.P.T., prices and notes in circulation

	INDIA				U. K.				
	E.P.T.	Price level	Notes in circulation Amount	Index	E.P.T.	Price level	Notes in circulation	Added in the year	E.P.T revenue
1938-39	....	109	Rs. 182 crores	100	60%	106	555	—	—
1939-40	50%	121	209	115	100	140	617	+62	27
1940-41	66 2/3%	141	241	132	,,	157	752	+135	96
1941-42	,,	187	307	170	,,	164	923	+171	269
1942-43	,,	311	513	280	,,	167	1089	+159	377
1943-44	,,	302	777	427	,,	171	1250	+161	498
1944-45	,,	292	968	532	,,	174	1400	+150	510
1945-46	,,	328	1162	638	,,	180	1370	— 30	486
							Total	+1010	3363

$ Data from Reserve Bank of India Report on *Currency and Finance* 1946-47 statements and XL Data from *The Economist* 16-11-46.

There has not been in India—or in Great Britain—any correspondence between the rise in prices and the levy of the tax. Prices began to rise even before the tax was imposed, perhaps because of reduced supply, increased demand and nervousness in the market, and certainly because of the increased quantity of money. There has been a closer correspondence between the monetary and price trends than between the latter and the tax. For, while the excess profits tax rate after 1941 was rigid at 66 2/3 per cent, prices continued to shoot up, and at the same time there was an increase in notes circulation. If prices did not keep pace with inflation it may be largely because of government action such as price control. And it may even be suggested that the excess profits tax countered the inflationist tendency and thus helped to restrain the rise in prices.

It is however, possible that on account of the imperfectly competitive conditions of the market during the war, the partially successful control over prices, and the laxity in industrial management on account of the entrepreneur's opposition to the levy there might have been a reflection of the tax on prices.

There is one kind of relationship between the excess profits tax and inflation that is popularly claimed but is really untenable. Characterising the tax as "a money-catching device in an inflationary economy," the *Eastern Economist* wrote:[190] "In 1944-45, total excess profits tax amounted to Rs. 110 crores: Compare this figure with the amount of inflationary note issue in the previous year, viz. Rs. 203 crores. The excess profits tax yield was, thus, about 55 per cent of total inflationary note issue in the previous year, the rate of excess profits tax being 80 per cent, ignoring evasions. This striking coincidence is not wholly fortuitous, for, as we have

190. 26th October 1945.

said, the successive doses of inflationary note issues caused the war time gap between price and lagging cost, i. e. the exces profits, to act as the government's tax-collector or fiscal agent, the tax being the successive dose of inflation which the government has inflicted on the public."

The trends of profits and prices in India [191] point out the want of correlation between the two as well as the substantial increase in real profits. The divergence between the excess profits tax revenue and inflation is clear from the data in Table XXXVIII. The experience of Great Britain conclusively proves[192] the untenability of the view quoted above. Not only were the annual tax receipts after 1940 very much more than the volume of notes added to circulation but also the total revenue from the tax in 1940-46 exceeded 3300 millions whereas the inflationary issue was 1010 millions, the revenue being about three times more. It appears, therefore, as inaccurate to suggest that the government inflated the currency on the one hand, and on the other, squeezed the taxpayer through the excess profits tax, thus burdening the community both ways, as it is to attribute abnormal profits in normal times to differential efficiency.

An important, though unintended consequenee of the excess profits tax was the modernisation of the Indian tax structure. The modern tendency as well as an axiom of social justice in taxation is the growth of direct taxes and their predominance in the budget.

191. *Supra* p. 282.
192. *Supra* p. 349.

TABLE XXXIX

E.P.T. and direct Taxation

	Tax Revenue. (including E.P.T. Crores Rs.	India Direct Taxes %)	Direct Taxes excluding E.P.T. %	U. K. %	Canada o/o	Australia o/o	U.S.A. o/o
1938-39	....	....	....	55.6	32·8	21·6	53·2
1939-40	....	....	....	55·6	28·8	22·2	52·9
1940-41	75	34	34	57·3	35·0	32·8	59·0
1941-42	97	37·7	32	61·4	47·9	51·7	60·6
1942-43	123	63·3	50	62·6	65·9	61·4	78·2
1943-44	172	67.1	47	63·1	62·9	66·1	86.4
1944-45	271	67·1	51	64·2	62·7	68·3	84·2
1945-46	311	57·2	46·5	63·1	...	....	....

Note: Column 4 indicates the proportion of direct taxes to the total tax revenue, the excess profits tax receipts being excluded *in both cases*. Columns 3 to 8 indicate the proportion of direct taxation to total tax revenue.

Until 1942 indirect taxation dominated the budget in India but later direct taxes asserted their position, partly because of the changes in income and super tax rates and partly of the excess profits tax. As shown in column 4, the latter tax made an appreciable difference in the importance of direct taxes.

Excess Profits Tax and Planning

It has already been indicated[193] that the excess profits tax can be converted into an instrument of planned production to divert resources into predetermined channels. Its applicability to India is illustrated below. A plan involves three features—the scheme of priorities, the rate of expansion and the pattern of location. No plan so far published in India contains a definite *scheme of priority.* "It is not possible, in our opinion," wrote the Government of India Advisory Planning Board,[194] "to fix definite and absolute priorities between industries." But, no plan can be worked,—in fact, can be called a plan—without some definite, though not absolute, scheme of priorities. For, while a simultaneous advance in all directions is desirable, it is not practicable, and at different times greater attention will have to be paid to some than to others.

Let us assume, therefore, a scheme of preferences[195] :

Group I: *Industries of national importance*, e.g. iron and steel, coal, heavy chemicals, electricity, banks, insurance, etc.

Group II: *Industries of second rate importance,* e.g. tea, pressing, oil, paper, cement, sugar, flour cotton, *etc.*

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193. *Supra* pp. 235—245

194. *Report* (1947) para 50; referred to below as *Neogy Report*. Also vide *Second Report on Reconstruction Planning* (1945)

195. This outline follows the order given by K.T. Shah, though in a different context viz., the problem of financing (*Neogy Report* pp. 36 and ff) The details put in are merely illustrative, and their relative importance may change.

Group III : *Enterprises becoming monopolies due to natural causes or public aid*, e.g. jute, glass.

Group IV : *Protected consumption goods industries and luxury goods.*

Profits are not material in nationalised enterprises such as defence and transport industries. Where private enterprise is permitted, as perhaps in the foregoing groups, the rate of normal profits may be in the descending order. Thus, supposing the basic normal rate[196] is 5 per cent on employed capital, the rates on *grounds of priority* would be 8 per cent for group I, 7 per cent for group II, 6 per cent for group III and 5 per cent for group IV. Within these groups, the *standard rate* as affected by risk and other factors[197] will be different for the different industries as determined by the Board of Referees, the procedure of enquiry being similar to that of the Tariff Board. For instance, if in group II oil is more risky than tea, the former would be given an additional percentage of normal profits, say, one per cent; if manufacture of face powder is less risky than that of lip-stick in group IV the latter would get an extra concession as below:—

Order of priority	*Basic rate*	*Priority rate*	*Standard rate*
I. Iron & steel	8% +	1=	9
Coal	8% +	0=	8
II. Oil	7% +	1=	8
Tea	7% +	0=	7
III. Glass	6% +	1=	7
Jute	6% +	0=	6
IV. Face powder	5% +	0=	5
Lip-stick	5% +	1=	6

The second factor in planning is the *rate of expansion.* Different industries are expected to expand

196. *Supra* pp. 152 and ff.

197. *Ibid*

in the planned period, say five years, at a particular pace, according to national needs and resources. Thus, in the Russian Second Five Year Plan (1932-37) productive capacity was to increase as :-pig-iron 2.3 times; coal, double; generator construction 2.4 times; automobiles, 4 times; locomtives, treble; rail road cars, 4 times; cotton industry, 1.5 times, etc. Some targets suggested in India by the Neogy Report are :[198]

Steel—	200	per cent increase
Pig iron—	300	,,
Soaps	200	,,
Sugar	100	,,
Plastics	50	,,
Ceramics	20	,,
Silk		consolidation etc,

These targets may be made the basis for additional rates of normal profits somewhat as below :

Rate of expansion.	Additionol rate of profits
1. Less than 100 per cent	½ per cent
2. Between 100 and 200 per-cent	1 ,,
3. ,, 200 and 300 ,, ...	1½ ,,
4. Over 300 ,, ...	2 ,,

That is, if acceleration in production is decided upon the rate of normal profits may be increased. And at the end of each period of planning, a revision may be made as in the case of protective duties.

The *pattern of location* implies the growth of certain industries in certain areas in preference to others. Thus, the *Neogy Report* has suggested[199] that no more paper industry should develop in Bengal or board mills in Assam, or sugar in the United Provinces and Bihar. On the other hand, paper and board

198. *Vide* pp. 103 and ff.

199. A number of these panels have made no specific recommendation regarding location e.g. chemicals, drugs, hosiery, etc.

production should be encouraged in Madras, Bombay and the Central Provinces, sugar in Madras and the Punjab; ready-made clothing industry in Delhi, Amritsar, Calcutta, etc.

Such a regionalisation is now proposed by rationing capital issues or by giving new concerns facilities such as finance and technical help. These devices can be bypassed and industrial dispersal upset by old concerns through a rationalisation of production processes, even if the capital expansion is prevented by law. The old firms might increase their total output and, thus, thwart regional development.

An alternative to these methods or at least a supplement to them is the variation of the normal profit rate as illustrated:

Industry	Region to be developed	Region where no further growth should be allowed	Regional rate
Paper	Madras, Central Provinces, Bombay	—	1%
,,	—	Bengal	Nil
Sugar	Punjab, Madras	—	1%
,,	—	United Provinces, Bihar	Nil

That is, the regional rate of normal profits in addition to the basic rate may be varied according to the need for developing a particular industry in a particular area.

Thus the way in which the excess profits tax can be utilised in planning production is by the adjustment of the basic normal rate of profits to social ends. *The basic rate*, which is the minimum for *any* private enterprise, should be linked to the scheme of priorities, the target of production and the regional distribution of industries, and should be determined *by the legislature*. But *the standard rate*, which is the adaptation of the group basic rate to the different kinds of industries within the groups, should be fixed by *a Board of Referees*. Under the British Excess

Profits Duty of the First World War, the basic rates varied between 6 and 11 per cent but the Board allowed additional percentages ranging from $\frac{1}{2}$ per cent in the case of cement manufacture,—the additional rate was also nil in some other cases such as boot-making and paint, colour and varnish manufacture,—upto $21\frac{1}{2}$ per cent in the case of gold mining. This kind of adjustment entails investigation into a class of business and, therefore, cannot be undertaken by a legislative body, but could best be done by an impartial expert non-official committee. Even a Board of this nature, however, cannot spare the time or energy to enquire into the numerous individual cases which require detailed enquiry. The *effective rate*, therefore, can best be left to *the administrative department* as in the case of the income-tax.

THE BUSINESS PROFITS TAX.[200]

It was soon realised that the excess profits tax had been prematurely abolished, and so, the business profits tax was introduced in the budget of 1947-48. The business community, which had agitated against the former levy, found that it had exchanged King Log for King Stork. The new tax was, of course, not readily accepted and even a Cabinet crisis was threatened on its account. Before it became law, the original bill also underwent substantial changes, both in the Select Committee and in the Legislature.

The Finance Member himself preferred the business profits tax to the old one.[201] "I decided against the excess profits tax because I think that, whatever may be its merits as a war time measure, it is a bad tax in the present conditions. It puts too high a premium on success and too high a penalty on failure in the pre-war years, although success may not have

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200. The B. P. T. Act 1947, Act No. XXI of 1947

201. *Legislative Assembly Debates*, 5th March 1947, Vol II no. 6 pp. 1539-40.

been due to efficiency and failure may have been due to causes beyond the control even of the most efficient management." Four reasons were given by him for not reviving the excess profits tax.[202] First, "the E. P. T. was very complicated and it was difficult to work, with the result that there were bound to be a large number of cases in arrears as there are to day." Secondly, "the incidence of the E. P. T. as between one trader and another was not fair because it depended too much on pre-war profits." Thirdly, "E. P. T. excluded incomes from vocations and professions." Fourthly, the B. P. T. is 'the easiest tax', and 'very simple'. "It is an easier tax to collect and easier tax to assess and, as it is, it will not fall heavily on the industry."

The business profits tax is, therefore, analysed below with three objectives in view: First, what are the important differences between the two taxes? Secondly, what are the limitations of the B. P. T. Finally, is it really the better tax? The main changes introduced in the tax structure by the Select Committee and the Assembly are noted below, but the close resemblance between the two taxes in many details is not pointed out in view of the elaborate analysis of the E.P.T. in the preceding pages.

The first significant difference between the two taxes lies in the Government's approach to them. The excess profits tax of 1940-46 was essentially a revenue instrument and was introduced to raise more funds in an emergency. The then Finance Member declined to base it on any ethical or social objective.[203] But the business profits tax is "related not to purely financial purposes, but to certain social objectives which . . . . . must be kept prominently in view,"[204] the aim being to reduce concentration of wealth.

202. *Ibid* 1st April, 1947, Vol IV. No. 6 pp. 2797-98. Finance Member's reply to the debate.

203. *Supra* P. 267

204. *Legislative Assembly Debates*, 28th Feb. 1947, Vol.II No.1.P 1332.

Further, the B.P.T. is wider in scope. It is intended to be an income tax "on a certain class of income" i.e., arising from business.[205] It is a peace-time levy, whereas the excess profits tax was essentially on the *excess* "arising out of the conditions prevailing during the present hostilities."[206] But in essence, the B.P.T. is an excess profits tax of the "High Profits variety," levied in normal times,[207] although it is a defective levy of that type. Like the E.P.T, it is confined to British India, and therefore, open to all the consequences of iudustrial and vocational migration described earlier.[208] The Government of India, no doubt, cannot tax businesses outside its boundaries, e.g. in Indian States, but it can prevent evasion by migration and achieve the social and financial objectives of the levy by adopting both the origin and residence bases, and providing double taxation relief, wherever necessary.

The B.P.T. is wider also because it affects certain vocations and professions[209] which were generally exempt from the E.P.T.; for example, solicitors, auditors, doctors and barristers—occupations depending wholly or mainly on personal qualifications and not employing considerable capital. The Finance Member opposed[210] exemption of these classes not on any grounds of principle but because the tax was not heavy and the incomes of solicitors and others had gone up, sometimes to 10 or 12 lakhs. Neither of these grounds can, however, justify the levy of the income tax twice over—once in the form of the business profits tax and, again, in that of the ordinary income and super taxes. Nor can it justify the restriction of the tax to certain professions only, unless the

205. B P.T. Act (1947) preamble.
206. E.P.T. Act (1940) preamble.
207. *Supra.* P. 20
208. *Supra.* 269—70
209. Section 2, (3)
210. *Legislative Assembiy Debates.* 1st April. 1947. Vol. IV No. 6. p. 2808.

policy is to discourage those occupations. The excess profits tax is a tax *in rem* and, therefore, can be levied along with the income tax, since they are two distinct taxes with distinct bases,—one a tax on business and the other a tax on persons—, thus, not involving double taxation or discrimination. But the B.P.T. has no justification, for, so far as the abatement is based on invested capital,—which is a characteristic of business,—it becomes a tax on business i.e., *in rem* and so far as it is not related to capital, i.e., on professions, it becomes a pure excess income tax i.e. *in personnun*. Thus, it is a discriminatory and inequitous hybrid.

The B.P.T. exempts from taxation not only profits exempted under section 4 of the Income Tax Act but also those of life insurance and any sum paid by government to a business by way of bonus or subsidy[211]. The provision relating to bonus was added by the Select Committee. The minority in the Select Committe was keen on extending exemption to all forms of insurance, banking, investment and public utility undertakings, and wanted special consideration to be shown to shipping. The exemption of life insurance and banking profits are open to the objections mentioned above[212] in connection with the E.P.T.

Public utilities, if publicly owned, should naturally be outside the scope of the tax,[213] but, if in private hands, cannot escape the tax. They may be entitled to other forms of concession such as generous depreciation allowances and liberal computation of capital but, because of their monopolistic position, cannot claim even a high rate of return. Similarly, in view of its national importance as well as infancy, shipping may be entitled to a higher abatement, for example, 7½ per cent, but not to total exemption.

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211. *Supra* pp. 273 and ff.
212. *Supra* pp, 53 and ff ; 308 and pp.
213. *Supra* pp. 136.

The exclusion of Government aid is unfair, for, a concern ordinarily profitable would not need any such help, and the assistance is given only to make up any difficiency in profits. The total gains of a concern, whatever their source, should, therefore, determine the taxability.

The exempted normal income or abatement in the B.P.T. is similar to the standard profits and the statutory per centage of the E.P.T. It is of two varieties: (1) a percentage on the invested capital; and (2) a fixed amount. In the original bill, the abatement was a flat rate of one lakh of rupees but the Select committee introduced differing criteria for different groups of assessees. It was 6 per cent for director controlled companies and 5 per cent for non-director controlled companies, on the capital on the first day of the chargeable accounting period, or one lakh of rupees whichever was greater; for firms with two partners it was one lakh; with three partners one and a half lakhs; and with more than three, two lakhs, irrespective of the capital invested. In accepting this modification, the Legislative Assembly changed the abatement for companies to a uniform rate of 6 per cent or a lakh of rupees whichever was greater. That is how the law stands.[214]

Abatement

The original bill was apparently non-discriminatory since all assessees were treated identically, but in effect, they were not treated equitably. For, as no account was taken of invested capital, there was inevitably *bias against* large and even medium sized organisations. Since some enterprises, especially of the basic type, such as iron and steel and automobiles, must necessarily be on a large scale, the abatement in its original form would have cut at the root of all large scale enterprise and generally of all joint-stock ones, and, thus, hindered the industrialisation of the country. Instead of encouraging the broad-based

214. Sections. 2. (1)

corporate organisation and helping better distribution of profits, the provisions would have favoured the growth of partnerships and proprietorships and so the concentration of wealth. The flat rate proposal, therefore, was indefensible from any point of view except that of administrative convenience.

The Select Committee's[215] and the Assembly's modifications also are defective. Two types of discrimination are introduced—one based on the industrial structure i.e., between companies and firms and the other on the basis of the number and type of owners i.e., not more than 4 partners are in effect allowed and only working partners are considered for abatement. These provisions may be compared with the E.P.T. where both the Income and Capital Standards prevailed. The statutory per centage, which varied between 8 and 10 per cent, was of limited application—applied only when the Income or Profits Standard did not hold good. On the other hand, the abatement on capital basis in the B.P.T. is limited to companies and thus a definite *bias is* shown against non-company forms of organisation. In the E.P.T. discrimination was made in favour of firms and a higher per centage was given, on grounds of personal equation, risk and administrative factors.[216] No doubt, the E.P.T. law became more cumbersome as a result of the concessions and alternatives but better justice was rendered. The reversal of this policy in the B.P.T. is hard to appreciate unless the the state wants to discourage the growth of partnerships and those having more than 4 partners; or, unless it is assumed that firms tend to exaggerate their invested capital and so a lower abatement would counter this tendency. If profits are dependent on invested capital, abatement on the capital basis should be allowed to firms also.

215. The minority in the Select Committee wanted the abatement to be raised to 7½ per cent.

216. *Supra*. pp. 158, 194

Again, the fixing of the maximum abatement to 2 lakhs of rupees unnecessarily restricts firms to 4 partners and has a tendency to multiply single proprietorships and partnerships of the small variety. Further, no social objective is achieved, because an income of one lakh, which is the taxable minimum, is certainly high enough to perpetuate the disparity in wealth. Moreover, the abatement does not provide for either differing efficiency of concerns or, what is more important, for the varying factors such as risk, social desirability, location and ownership, as between different industries. If, for instance, film business is more risky than biscuit making, it is in the interests neither of the nation nor of the business to allow both concerns 6 per cent on capital, There should be a discriminatory rate and such a contingency was automatically provided in the E.P.T, of the Income Standard variety, and even in the statutory percentage variety where the appellant authority could grant a higher percentage. The B.P.T., therefore, is extremely rigid in its abatement and, thus, inequitable between industries. It is definitely harmful in so far as it encourages the prevalent tendency for the less risky and less desirable consumption and luxury goods to expand.

Further, it is not clear why the abatement should exclude sleeping partners, for, a partner is entitled to a return on his capital not only for lending but also for risking his funds. Partnership profits include both these elements. The exclusion of sleeping partners is fraught with unwelcome consequences, for instance, evasion by the sleeping partner becoming nominally a working partner or by a high rate of interest being given for his capital. Further, in a country where banking facilities, specially for industrial advancement, are meagre and joint stock concerns undeveloped, a poor entrepreneur with initiative, brains and ability is suppressed since he cannot get a loan easily and since he does not share profits with a sleeping partner who can risk his

capital in anticipation of a share in the profits. No social or industrial interest is served by excluding sleeping partners.

The best way, therefore, so far as abatement is concerned is to accept the capital standard in all cases and relate the return to the industrial needs and to the efficiency ratio. So long as the B.P.T. is meant to be confined to one year, those defects may not be material, but if it is to be permanent a change in the normal return basis is absolutely essential.

An important feature of the B.P.T. is the rate of tax. In the original bill and the Select Committee the rate was 25 per cent but the opposition desired to lower the rate to 12½ per-cent. Under the compromise terms it was reduced to 16 2/3 per cent, This rate may be contrasted with 66 2/3 per cent under the E.P.T. Two limitations in the B.P.T. in this respect stand out. First, the absence of graduation. So long as the abatement is related to capital, a flat or proportional rate is obviously unfair.[217] Secondly, if the abatement is resonable and linked to industrial needs the rate could be higher, perhaps 20 to 40 per cent.[218] In fact, business interests were prepared to accept the E.P.T, at 33 1/3 per cent in place of the B.P.T.

Tax Rate

Under the B.P.T. only a part of the invested capital is taken into account. Under schedule II, simplicity is achieved at the cost of equity. Capital comprises paid-up share capital and reserves in so far as they are not allowed in computing profits under the Income Tax Act. In the case of investment companies, the cost of investment is deducted if its income is not included in the taxable amount. Premium as shares is included in the paid-up capital while deposits with the Central Government are not deductible as investments.

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217 *Supra* pp. 53 and ff 308 and ff.

218. *Ibid.*

This scheme is defective in any respects, and the minority in the Select Committee wanted the E.P.T. precedure to be adopted. For, the E.P.T. was definitely fairer on the computation of capital though Schedule II was lengthy, involved, complicated and confusing. The B.P.T. altogether brushes aside the invested capital concept. The capital of a business includes more than the paid-up amount and reserves, and in fact, it may be argued that the former should not be included. The block account, working capital, reserves and other kinds actually utilised in earning the profits and running the concern should be the basis of calculation and a valuation of these on some accepted basis should be the first concern.[219] Even a low abatement on the full amount of employed capital would be preferable to a higher return on partially computed capital. But the inclusion of premium on shares is questionable unless the excess amount is employed in the running of the concern in tth form of machinery etc. The emphasis should, therefore, be, not on the shareholders' contribution but, on the employed capital.[220] Not only was the E.P.T. basis of capital computation fairer but also it was administratively more convenient. Much of the work of compultation had already been done under the E.P.T., and both the tax authorities and the assessees were familiar with it.

Administration

On the administrative side also, there are noticeable differences between the B.P.T. and the E.P.T. There are no special officers to administer the B.P.T. and the normal tax authorities look after it, perhaps because it is regarded as an income tax. In the E.P.T. there were officers of various grades, though many of them were, in fact, income tax officers too. There is, thus, a merger of the B.P.T. in the income tax administration while there was an emphasis on

219. *Supra* pp. 174 and ff.
220. Schedule II

the difference between the income tax and the E.P.T. Moreover, the Board of Referees, so characteristic of the E.P.T., is totally absent in the B.P.T. The income tax officers have, under the B.P.T., more powers e.g. in making provisional assessments, than the E.P.T., officers had.

This non-duplication of administration has gone a long way to simplify the B.P.T. Simplicity is perhaps its greatest merit just as complication was the greatest drawback of the E.P.T. The B.P.T. Act is shorter, more direct and in simpler language. For instance, Sec. 7 of the B.P.T. relating to the change in persons carrying on business, puts in two paragraphs what Sec. 8 of the E.P.T,, under successions and amalgamations takes fifteen long and involved paragraphs. Similarly, the provisions relating to in terconnecting companies in Sec. 8 of the B.P.T. are practically the same under the E.P.T., but the latter was too long and complicated. So also the provisions for appeal under the B.P.T. are simpler. In fact, there appear to be unnecessary clauses and involved expressions in the E.P.T. which have been successfully avoided in the B.P.T. Some of the provisions may have been necessary under war conditions and when contrasting pre-war and war profits. The E.P.T. suffered because of a double test of standard profits and, especially, by the adoption of the income standard. It also suffered because the E.P.T. officer had less powers than under the B.P.T. This means that a simplification of the E.P.T. on the model of the B.P.T. would remove the most important objection to it. Additional simplicity can be achieved by the adoption of the Capital Standard.

In the original B.P.T. bill no appeal was allowed in the allocation of the tax between a principal and a subsidiary by the income tax officer. But the Select Committee has introduced an appeal as in respect of assessment. Whereas the original bill allowed no interest on excess taxation collected under provisional

assessment, the Select Committee has allowed 2 per cent interest from the date of payment of tax to the date of refund. This interesting provision was not found under the E.P.T and it is a welcome change since the B.P.T. officer who wields considerable powers under provisional assessments will not hastily fix the amount payable. In fact, this provision balances the greater powers of given to the administration. The time limit for submission of return as well as for appeal against assessment was, as in the E.P.T., changed to 45 days from 30 days. Similarly the maximum period for which profits escaping assessment could be reopened has been reduced by the Select Committee from 5 to 4 years. These provisions naturally benefit the tax-payer.

Two important provisions found in the E.P.T. appear to be absent in the B.P.T. They relate to artificial transactions and relief from double taxation. Perhaps being an income tax the provisions under that tax apply to the B.P.T. also. Like the E.P.T., the B.P.T. is also first deducted for income and super tax purposes.

There are, however, certain important criticisms of the B.P.T. of which no evaluation is possible. "Even the amended proposals for taxing industries will hamper production, inordinately delay programmes of replacement and rehabilitation, shake one's faith in private initiative and private enterprise, dry up the sources of capital and, thus, make it impossible for new industries to come into existence."[221] This sums up the opposition to the tax by business interests in the Legislature[222] and outside[223]

The effects of any tax can be gauged only after the tax has been in operation for some time, and economic equilibrium is re-established after the disturbances of the first impact. But, while recognising

221. *Commerce.* 29th March 1947 p. 2.

222. Vide *Legislative Assembly Debates* 4th March 1947 Vol I. No 10 pp. 1398—1292.

223. e.g. The *Eastern Economist* Supplement 28th Feb. 1947.

that some modification in the tax is both desirable and possible, the experience of the E.P.T. described earlier belies the fears of the critics and suggests that they are exaggerated. " This is a cry ", observed the Finance Member,[2] "that is being raised and that has been raised . . . to mislead the honest people. This is really the only way in which they could try and prejudice the mind of the people at large. I am sorry to say that the manner in which the propaganda is being carried out is not the way in which those interests can influence me. I am neither going to be coerced nor black-mailed into accepting a position which I do not feel is justified in the interest of the country." Every new tax has been opposed. When the modern income tax at a very low rate was introduced in India in 1916, it was un-welcome. "The scheme of enhanced taxation which the bill embodies", observed a member of the Legislature at that time[226], "is accepted by the country as a war measure ; such taxation cannot be tolerated on the restoration of normal conditions." The businessman's attitude to the E.P.D. of 1919 and the E.P.T. of 1940 has been quoted earlier[227]. Such opposition was found in other countries also.[228]

The B.P.T. however, has its limitations as pointed out above. With the modifications, the tax will prove not a bad one. As it is, it is not superior to the E P.T but as modified, it will become the E.P.T. advocated in the preceding pages. But then, is the E.P.T. desirable ? The drawbacks of the E.P.T. pointed out by the Finance Member[229] are true of the tax as it existed in 1940–46. Its complications and the difficulties in working it were partly unnecessary. They could be easily avoided by simplification on the model of the

226. Quoted in J.P. Neyogi : The *Evoluation of the Indian Income Tax* P.135

227. *Supra* py.262

228. *Supra*. P.8.

229. *Supra* p. 357 and ff.

B.P.T. Act of 1947. Further, the difficulties were the result of the dual normal standards and especially of the adoption of the profits standard.

THE FUTURE OF THE EXCESS PROFITS TAX

Should, then, the excess profits tax be resurrected and permanently incorporated into the Indian budget as the income and supertaxes have been? The answer depends on three considerations: the need for the tax; the alternatives to it and the effects of the levy.

The necessity for the tax may be viewed from the standpoints of revenue and social policy: The abolition of the salt tax, other forms of direct relief to the poorer classes, the loss of income on account of the protectionist and prohibitionist outlook of the state, the introduction of social security schemes and the financing of planned economy emphasise the urgent need for funds. In the existing conditions of the country and of the tax structure, the only resort is to direct taxation.

The social policy of the country was put by the first Indian Finance Member thus:[230] "India is a land of glaring contrasts and disparities. . . The conditions created by the last war served to accentuate these disparities. . . the rich became richer and the poor poorer. . . . My budget proposals. . . . represent . . . . the first stage of a policy of social justice and development which, it will require years to bring to full fruition." This policy is already practised in advanced Western countries, and it will be the policy of the new India, whoever may be in power. There are two ways of executing it: one, the policy of socialisation of industries—already accepted by the government—and the other, the reform of direct taxation by steepening progression, by new taxes such as the Death Duty and by similar means.[231]

230. *Legislative Assembly Debates* 28th February 1947, Vol II No. 8. p. 1333.

231. This problem is discussed in a forthcoming publication *Tax Reform in India.*

It is not the present policy of the state in India[232] completely to displace private intitative, which will, therefore, play a considerable part in the industrial development of the country. The problem, therefore, is one of dovetailing private enterprise with the National plan by diverting the former into the planned channels. Moreover, for some time to come conditions of production will continue to be monopolistic and control over them will be essential in order to prevent the expolitation of the consumer, in the form of excess profits resulting from the divergence between price and average cost, i.e., "profits from squeezing the public by rings and by the ubiquitious. . . . price maintenance agreements, by feather-bedding and the suppression of new processes, by the inert weight of monopolistic inefficiency' by sheer stertorous inactivity behind a safe barricade of licensing regulations."[233] The prevalence of this tendency towards abnormal gains, not only during emergencies but also in the inter-war-period, is clearly indicated in India.

Thus. financial necessity, social policy, planned economy, prevailing industrial conditions -- all suggest the need for a radical change in our outlook and for a new profits-*cum*-taxation policy in India. It is, however, too much to believe in the post-war world that the destruction of the hope and possibility of large profits means nothing less than the destruction of the enterprise system and destruction of the enterprise system means the destruction of political freedom and that profit, the price of enterprise, is equally the price of liberty.[234] On the other hand, "The right profits policy is one which would remove from profits the stigma of monopolistic extortion by

232. *Report of the Advisory Planning Board*, paras. 56-57 Also the Finance Member's declaration *Legislative Assembly Debates* 4th March 1947

233. *The Economist* 8th February, 1947, P.226

234. *The American Individual Enterprise System*, Vol. I p. 480.

breaking down the adhesions and limbering up the ankylosed joints of the private sector."[235]

A move in this direction has already been made in the world—over and especially in India in the form of the profits taxes. "If soaking the rich is the order of the day," observed *the Economist*,[236] "then the best way to do it is by means of death duties. The second best is by a wider margin in the income tax between earned and unearned incomes. The worst of all-the worst in equity and worst in its effect upon enterprise—is a tax on profits as such." In our own country, the proposals to abolish Zamindaris, to levy the Estate Duty and to reform the income tax, and the recent levy of the Business Profits Tax are attempts to reorient fiscal policy.

None of these alternatives, however, is an adequate substitute to the excess profits tax.[237] The Zamindari Abolition Bill, whatever its merit, does not affect industrialisation nor is it financially important.

The Death Duty, which is under consideration, has long been overdue in India. But it does not serve the purpose described above, for, it is an indefinite source of revenue and its success in the social atmosphere of India is uncertain. Further, as it is collected at death, it cannot prevent exploitation of one class by another during the life time of the estate-owner. Finally, it cannot be harnessed for planning private investment and for aiding the National Plan. It is also possible to evade the tax in its present from by using up the high profits and incomes *inter vivos*. Even for purposes of reducing inequalities, it may be useful only in the long—perhaps very long—run. While, therefore, the Death Duty is an essential part of a modern tax system, it cannot acheive the ends described above.

Similarly, a steeper rate of income and super tax-

235. *The Economist*, op cit.
236, *Ibid*
237. *Supra*. PP. 252—260

ation, and the distinction between earned and unearned incomes are very desirable in a progressive state. Although they act as an important revenue source, they, however, cannot serve the planning objective. Morevor, they affect all incomes and not abnormal turmes profits.

The limitations of the Business Profits Tax have been discussed above.[238]

A new profits policy in terms of taxation, therefore, becomes desirable, and the excess profits tax of the Capital Standard variety deserves a trial as an alternative. The theory of the tax and the experience in India, as in other countries, point out the effects of the levy on production and other economic aspects. Indian experience between 1940 and 1946 has thrown up no particularly harmful consequence of the tax on prices, industrial activity, growth of investment and companies, and the prosperity and stability of concerns. The undesirable effects, if any, may be further reduced if the tax structure follows the suggestions made in the preceding pages, such as the adoption of the Capital Standard, averaging of profits, reasonable depreciation allowances, a standard normal rate providing for risk and other elements, an effective rate linked to differential efficiency, the opportunity to appeal to an impartial and independent tribunal, and more than all the simplification of the tax law, structure and administration. In other words, the tax should recognize profits as a return for the services genuinely rendered, reward the captain of industry for enterprise and judgment, indefatigable probing after better technique, economy and boldness, the divining of new needs and the harnessing of new resources and, in fact, for all those qualities which lie outside the scope of plodding routine administration[239]—in so far as these qualities are within the framework of the National Plan and are conducive to optimum social welfare and not maximum individual benefit.

238. *Supra* pp 357 and ff.

239. *The Economist op—cit.*

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ABBREVIATIONS USED

A.E.R.	American Economic Review
Annals	Annals of the American Academy of Political and Social Sciences.
A.P.S.R.	American Political Science Review.
Carnegie	Publications of the Carnegie Endowment fund for International Peace.
C.J.E. & P.S,	Canadian Journal of Economics and Political Science.
E.J.	Economic Journal.
Eco. Rec.	Economic Record.
Eco.	Economica, L.S.E.
H.B.R.	Harvard Business Review.
I.L.R.	International Labour Review.
I.J.E.	Indian Journal of Economics, Allahabad.
J.A.	Journal of Accountancy.
J.R. Stat. S.	Journal of the Royal Statistical Society,
J.A. Stat. S.	Journal of the American Statistical Society.
J.P.E.	Journal of Political Economy.
R.E. St.	Review of Economic Statistics.
R.E.S.	Review of Economic Studies.
P.S.Q.	Political Science Quarterly.
Pol. Quar.	Political Quarterly.
Pub. of A.E.A.	Publications of the American Economic Association.
Q.J.E.	Quarterly Journal of Economics.

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